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KAISER-FRAZER v. OTIS: A LEGAL AND MORAL ANALYSIS

DAVID C. BAYNE, S.J.

IT is an unusual day in the financial and legal community when an underwriter terminates a contract on the day of closing. It is perhaps an even more unusual day when the esteemed Second Circuit, reversing the District Court, upholds that underwriter in its untoward and almost unparalleled action. *Kaiser-Frazer v. Otis*¹ is an unprecedented case. The law is not particularly new, but the peculiar juxtaposition of the facts against the law is startlingly new.

The public interest in the *Otis* case is great. The alarming stabilization, the unexpected termination of the agreement, the controverted *Masterson* case, long months of SEC investigation of Otis' activities, registration revocation proceedings, NASD suspension of Otis, the inception of the Kaiser-Frazer litigation, the bankruptcy of Otis & Co., the secret investigation of the SEC by the Heller Committee, and finally the reversal by the Court of Appeals have all attracted national notice. But there is much more behind the *Otis* case than mere public appeal. It is a singularly important case from many far-reaching aspects.

Otis represents a strong reaffirmation of the inviolability of the American courts. In the face of an unhesitating lower court, a strong public opinion flamed by months of SEC hearings and investigation,

¹ 195 F. 2d 838 (C.A. 2d, 1952). Argued before Augustus N. Hand and Clark, Circuit Judges, and Brennan, District Judge Hand, C. J. delivered the unanimous opinion of the Court.

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with apparently every emotional reason to affirm the \$3,000,000.00 Kaiser-Frazer judgment, the Court of Appeals reasoned to a strong, unbiased reversal.

Otis epitomizes the legislative protection to the public investor. In *Otis* the courts have restated with new authority the vigor of the disclosure provisions of the Securities acts. In such an inconspicuous and apparently trivial thing as a footnote can lie the difference between honest disclosure and material misrepresentation.

Otis stands as a fine testament of the clear logic and sound moral principles of the Court. In this day when the pragmatist and legal realist is basing his actions on expediency and shifting relativism, it is a milestone when such fundamental principles as underlie *Otis* are reasserted. In this day when natural law is condemned on many sides, it is a refreshing thing to be able to point to such a clearly reasoned instance of the natural law in action and application.

This is the broad ideological attitude we might take in beginning a study of *Otis*, in placing the case in its full perspective in our times. It is not good to do otherwise. Our days are fraught with too many pitfalls for our nation's future for any thinking man, especially a lawyer, to approach a socio-moral-legal problem out of the context of our total national milieu and isolated from the broad conflicts within our nation. The onus is great on the lawyer to approach every development in his field from the aspect of the social physician, from the viewpoint even of the moral theologian.

The consideration of the *Otis* case will proceed in three parts: (I) *The Facts*, in detail. (II) *The Solution*, which will present the thesis of the commentary, and outline the burden the treatment will attempt to carry. (III) *The Legal and Moral Analysis*, which is the body of the article and the proof of the thesis.

PART I—THE FACTS

The central action, in a complicated network of litigation² involving Kaiser-Frazer Corporation and Otis & Company,³ began with a

² Exclusive of the parent case there are four broad areas of litigation: (1) A series of stockholders' derivative actions, charging in general breach of trust, fraud, and collusion: *Masterson v. Kaiser-Frazer, Otis & Co., et al.* in the Circuit Court for Wayne County, Michigan, on February 9, 1948; *Stella v. Kaiser-Frazer Corp.*, 81 F. 2d 807 (S.D. N.Y., 1948); *Pergament v. Kaiser-Frazer, et al.*, 93 F. Supp. 13 (E.D. Mich., 1950); *Lefker v. Kaiser-Frazer et al.*, D.C., Del., June 30, 1948; *Otis & Co. v. Kaiser-*

³ Kaiser-Frazer Corp. is a Nevada corporation; Otis & Co. a Delaware corporation qualified to do business in New York.

judgment entered on July 10, 1951, by the District Court for the Southern District of New York, Clancy, J., sitting without a jury, in the amount of \$3,120,743.51 in favor of Kaiser-Frazer in an action for damages for breach of an underwriting contract.⁴

On appeal, the Court of Appeals, Second Circuit, reversed and remanded with orders to enter judgment for Otis. Kaiser-Frazer filed its Petition for Writ of Certiorari with the Supreme Court of the United States on June 12, 1952.⁵ On October 20, 1952 the Petition was denied.⁶

Early Antecedents

Kaiser-Frazer was organized in August, 1945, and had virtually no production during that year, nor in early 1946. By the end of 1946 production increased, reaching volume in the spring of 1947. Otis & Co. had successfully handled two previous flotations for Kaiser-Frazer,⁷ first at its inception and again in January, 1946. The issue which was the subject of the contract under litigation was contemplated for very early in 1948. Although the automotive industry

Frazer, et al., D.C., Del.; *Fleming v. Kaiser-Frazer, et al.*, July 9, 1948, state court of California; (2) Three actions involving the Securities and Exchange Commission and Otis & Co.: *S.E.C. v. Otis & Co. et al.*, Civil Action No. 28371, D.C., N.D., Ohio, E.D., a statutory injunction suit. In the Matter of Otis & Co., United States of America, before the S. E. C., an administrative proceeding in which the S. E. C. was examining the conduct of Otis to determine whether Otis' registration as a broker and dealer should be revoked. *Otis & Co. v. National Association of Securities Dealers, S. E. C.*, DDC, No. 329-49; (3) Action by the S. E. C. in the matter of collusion in the Master-son Case: *S. E. C. v. Harrison*, 80 F. Supp. 226 (D. Ct. D.C., 1948); (4) A bankruptcy proceeding by Otis: *In re Otis & Co.*, 104 F. Supp. 201 (E.D. Ohio, 1952). The unpublished account of the Congressional hearings in connection with the activities of Otis & Co. is in General Docket, Kaiser-Frazer Corporation Docket, File 4-15-1-2, Docket Section, Securities and Exchange Commission, Washington, D.C.; Study of S.E.C., 82nd Cong., Final Report of S. E. C. Subcommittee to Committee on Interstate & Foreign Com. G.P.O. (1952).

⁴ The action was originally begun on February 13, 1948, in the Supreme Court of the State of New York and removed to the District Court for the Southern District of New York on diversity of citizenship. This opinion was not reported and appears in the Briefs and Records for the United States Court of Appeals, Second Circuit, Vol. V., Exhibits, at 3057, and in the Petition for Writ of Certiorari, Appendix "A," in the Supreme Court of the United States, October Term, 1952, No. 123, *Kaiser-Frazer Corp. v. Otis & Co.*

⁵ Brief of Respondent in Opposition was filed on August 1, 1952.

⁶ 73 S. Ct. 89. Mr. Justice Black and Mr. Justice Clark took no part in the consideration of this application.

⁷ The same group of three underwriters, headed by Otis, made the three offerings, First California Company, a California corporation, Allen & Co., a New York partnership, and Otis. The first issue in September, 1945 was sold to the public at \$10.00 per share in the amount of \$17,000,000.00. In January, 1946, the second issue sold at \$20.25 in the amount of \$36,000,000.00.

overall was enjoying a strong sellers' market, Kaiser-Frazer was yet a fledgling and by no means safely established in the field. Until the early months of 1947 production was limited to two medium priced models—the Kaiser and Frazer. Losses for 1946 were over \$19,000,000.00; for the first quarter of 1947, over \$3,000,000.00. Kaiser-Frazer had paid no dividends since organization.

The first overture for the third flotation came in May, 1947, when Edgar Kaiser approached Otis. Kaiser was told that a public offering was inadvisable until a more substantial earnings record could be shown. Later, on December 20, 1947, Henry and Edgar Kaiser telephoned William R. Daley, president of Otis, and advised him that the firm had been making excellent profits and wished to begin the issue.

By January 6, 1948, Kaiser-Frazer filed with the Securities and Exchange Commission a Registration Statement for the issue of 1,500,000 shares of common stock. Before the statement could become effective, however, Kaiser-Frazer stock dropped from 14½ to 11½ on January 26, and the issue was postponed by Kaiser-Frazer. This delay resulted in amendment of the Registration Statement and the accompanying Prospectus. Whereas the earnings record had previously been carried up to and including the month of November, it was now extended to year-end. The issue was contemplated for February.⁸

The Contract

Meetings between Kaiser-Frazer and Otis were resumed on January 30, and again on February 2, and 3. The stock had fluctuated on the market over this period reaching a 14 high. On February 3, it was 13½. On February 3, agreement was reached and the contract in writing was signed in New York City. The three underwriters were to take 900,000 shares at \$11.50 per share, with \$1.00 to the brokers, and sale to the public at \$13.00. It was a several agreement, 337,500 shares going to Otis and First California and 225,000 going to Allen. Although there was evidence of hesitation on the part of Otis in going forward with the issue,⁹ the contract was signed at 5:30 P.M. on February 3, and the attorneys for Kaiser-Frazer appended a rider to the

⁸ Strictly, Kaiser-Frazer was not required to list earnings to year-end, as the Brief for Appellant, Otis, states at page 13. The Commission requires the earnings record up to ninety days prior to the issue, which would mean November was the last required month.

⁹ Record, United States Court of Appeals, For the Second Circuit, Vol. III, page 1428. Henceforward this record will be cited:—R., III, 1428.

front of the Prospectus (there were some last minute changes in detail, principally the reduction of the issue from 1,500,000 to 900,000 shares) and the SEC immediately made the Registration Statement effective on that same late afternoon.

The contract, which provided that Kaiser-Frazer was to deliver, and Otis to pay for, the 900,000 shares of common stock (February 9, 1948, was the closing date), carried several conditions to performance by Otis. The principal conditions relevant to the litigation were attached to the accuracy of and compliance with the following two warranties and representations: (1) That the Registration Statement (including the Prospectus) would fully comply with the Act and the Regulations of the SEC and contain neither a material misrepresentation nor non-disclosure. (2) That Kaiser-Frazer's counsel was to deliver an opinion satisfactory to Otis' counsel that there were no material legal proceedings pending against the issuer.¹⁰

The Registration Statement and Prospectus

At the base of the entire *Otis* litigation, first from the factual standpoint and later from the legal, lie the Prospectus and the statements and figures contained therein on page 7. Except for deletions of non-pertinent matter, the following is the exact reproduction of the relevant parts of page 7:

SUMMARY OF CONSOLIDATED SALES AND EARNINGS

The following summary reflects consolidated sales and earnings of the Corporation from its inception to December 31, 1947. The information for the period ended December 31, 1945, and the year ended December 31, 1946, as shown in the table, and for the six months ended June 30, 1947, (as explained in note 2) has been prepared from profit and loss statements examined by Touche, Niven, Bailey & Smart and should be read in conjunction with the financial statements for such periods included herein and the accountants'

¹⁰ The Contract reads: "Section 1. Representations and Warranties by the Company. The Company represents and warrants that:

...
(c) When the Registration Statement becomes effective, the Registration Statement and the Prospectus will fully comply with the provisions of the Act, and the rules and regulations and instructions of the Commission thereunder; and neither ... will contain any untrue statement of a material fact nor omit to state any material fact ...

(f) There are no suits pending or ... threatened against the Company which affect any substantial portion of its property or ... business ..." R., I, 14, 15.

Section 3. Conditions of Underwriters' Obligation. The obligations ... of the Underwriters to purchase ... the Shares shall be subject to the accuracy of and compliance with the representations and warranties of the Company contained in Section 1 hereof ... R., I, 20. See also:—Sec. 1(e), R., I, 15; Sec. 3(e), R., I, 23; Sec. 3(b) (vi), R., I, 20–22.

report thereon. The information shown in the table for the eleven months ended November 30, 1947, and the breakdown into the three fiscal quarters and the two months period comprising such eleven months, has been taken from profit and loss statements prepared by the Corporation from its books and accounts, without audit, and should be read in conjunction with the unaudited eleven months financial statements and schedule included herein. The tentative information shown in the table for the quarter and for the year ended December 31, 1947, has been prepared by the Corporation from its books and records, without audit, on the basis of a preliminary 1947 closing made at January 23, 1948.

Period	Sales and Miscellaneous Income	Cost of Sales	Selling and Adminis- trative Expenses	Other Deductions or Credits* —Net	Net Profit or Loss*
From August 9 to December 31, 1945.	\$ 10,979	\$ 224,607	\$ 551,988	\$ 7,104	\$ 772,720*
Year ended Dec. 31, 1946	11,657,972	28,092,530	2,940,877	90,754*	19,284,681*
Eleven months ended November 30, 1947	227,560,032	204,674,595	6,751,960	637,729	15,495,748
Quarter ended March 31, 1947 (2)	27,305,035	29,366,660	1,093,542	81,127	3,236,294* (1)
Quarter ended June 30, 1947 (2)	53,142,946	50,255,274	1,640,776	198,641	1,048,255 (1)
Quarter ended Sept. 30, 1947 ..	78,527,735	67,890,777	2,150,261	209,388	8,277,309 (1)
Two months ended Nov. 30, 1947	68,584,316	57,161,884	1,867,381	148,573	9,406,478 (1)
	*	*	*	*	
Quarter ended Dec. 31, 1947 (4)	101,999,563	84,519,665	3,850,916	213,121	13,415,861 (1)
Year ended Dec. 31, 1947 (4)	260,975,279	232,032,376	8,735,495	702,277	19,505,131 (1)

Notes:

(4) The tentative information for the quarter and year ended December 31, 1947, reflects various substantial year end adjustments including provision for certain reserves and a material increase in inventories to conform to the results of the complete physical inventory taken by the Corporation as of December 31, 1947.¹¹

The Prospectus is prepared from figures contained in the Registration Statement.

The Offering

On February 3, the market closed at 13½ and on the 4th Otis solicited its brokers. The market was poor. By 1:00 P.M. the offering was terminated with approximately half of the shares unsold. On that same day overtures were made by First California and Otis to cancel the issue. Cyrus Eaton, for Otis, pointed out that a forced sale could

¹¹ Prospectus, 1,500,000 Shares, Kaiser-Frazer Corporation, Common Stock, dated February 3, 1947, 33 pages. Reproduced in the essential part (page 7), in the Brief for Appellant, United States Court of Appeals, Appendix A, at page 67.

be disastrous, that it would "end up with hell-a-poppin'."¹² These suggestions were rejected by Kaiser-Frazer.

During the period from February 4, to 9, many attempts were made on the part of Otis and First California to modify the arrangements, but without avail. Kaiser-Frazer stock remained at a figure below the intended offering price.¹³ The brief for Otis in the Court of Appeals states that Otis was at that time "exploring its legal defenses with counsel."¹⁴

On the date of closing in Cleveland, the proceedings and discussions were protracted throughout the day. Otis finally rejected the opinion of Kaiser-Frazer counsel that there was no outstanding litigation against the corporation and refused to accept the proffered stock. Word had come from the press that a certain James F. Masterson, a Philadelphia attorney and shareholder in Kaiser-Frazer, had that morning at 9:30 initiated a shareholders' derivative suit in the courts of Wayne County, Michigan.¹⁵ Masterson asked for an injunction restraining the issue by Otis, and for an accounting of profits from certain allegedly inside and improper operations. First California joined Otis in rejecting counsel's opinion. Allen remained ready to perform. Otis and First California served notices of termination of their obligation under the contract.¹⁶ There was no evidence that Kaiser-Frazer had not come prepared to perform.

The District Court

Kaiser-Frazer came into the District Court with three major allegations:¹⁷ (1) Otis was guilty of a breach for failing to accept and pay

¹² R., I, 329-32; IV, 2016-21.

¹³ Kaiser-Frazer stock, on the New York Curb Exchange, dropped to a low of 2½. The value as of April 1, 1953 was 5½ per share.

¹⁴ Brief for Appellant, 18; R., I, 450, 405, 437-8.

¹⁵ This case is discussed *infra*, p. 139.

¹⁶ Otis explains the reason for refusal: "Between February 4 and the closing date, February 9, Otis and First California separately proposed various formulas for settlement of the controversy (R. 356, 563-65, 405 et seq., 1446-47, 1488-89). Otis offered to prove that during this period it had begun to check the information received by its salesmen from Kaiser-Frazer dealers, and although in the brief time available its investigation could not be concluded, it believed that the Company had misrepresented and concealed essential facts from the underwriters—a belief which was completely justified as the facts in this record now show (R. 1434). These facts were peculiarly of a nature to be reflected in the attitude of the general public who were prospective purchasers of the securities. They related to the adverse consumer attitude and dealer position with respect to the Company's cars, particularly the high-priced models." Brief for Appellant, 17.

¹⁷ These are set out indirectly in the Court's opinion at R., V., 3072. See also 195 F. 2d 838, 839, 840 (C.A. 2d, 1952).

for the stock. Kaiser-Frazer asked total and special damages in the amount of \$17,419,819.00 arising out of manufacturing profits lost due to the unavailability of the capital expected from the issue; (2) Otis had collusively inspired the Masterson suit and thereby repudiated the contract without excuse; (3) Otis had induced First California to breach, and was liable in damages therefor.

Otis answered with two major (and several lesser) affirmative defenses: that it was relieved of any obligation by (1) the Masterson suit, and, (2) breach of the warranty (and hence of the condition precedent to performance) that the Registration Statement and Prospectus would contain neither misrepresentation nor non-disclosure of a material fact. Otis claimed, *as the District Court put it*, that the "earning summary in the prospectus gave a false impression,"¹⁸ and hence misled both Otis and the public.

¹⁸ Opinion of the District Court, R., V, 3076. Otis did, in fact, found its case in the matter of the alleged non-disclosure and misrepresentation on two distinct instances: (1) the December earnings figure, and, (2) the non-recurring profits realized from the sale of two special models, the Manhattan and the Custom. In its briefs for both the District and Circuit Courts, Otis placed almost equal stress on the two instances, but when the Circuit Court relied solely on the December earnings for its decision, Otis henceforward concentrated on this point. Space limitations make it advisable to confine consideration of the non-recurring profits from the Manhattan and Custom models to the footnotes.

Faced with \$23,000,000.00 in losses to March, 1947, Kaiser-Frazer endeavored to tap the sellers' (R. V, 2920, 2928, 2930) market in the higher price range. Two new models were introduced, in the Buick price field, first the Frazer Manhattan and later the Kaiser Custom. Both cars were differentiated from the regular models only in price, which ranged up to \$500.00 higher, and in trim and upholstery, but not otherwise. R., III, 1337; IV, 1951.

By May, 1947 the Company showed profits. During August to December, 1947 68% of Kaiser-Frazer profits were due to the Manhattans and Customs. R., V, 2760. Over this period, however, the sale of these models gradually decreased:—

	% of Manhattans and Customs to Total Cars Sold
October	50%
November	39%
December	32%
January	17%

Concurrent with this drop, the Company cut production from 50% of total output to less than 20% by the date of the Prospectus. Projected production, moreover, was set at 16% for the five months following the date of the Prospectus. R., V, 2760, 2777, 2754, 2766–67. Otis pointed out that cessation of this profit explained the drop in December earnings, but that cause for the drop, and the non-recurrent nature of the profits, were not disclosed in the Prospectus or the Registration Statement, nor to Otis itself. R., III, 1509–11, 1515, 1603, 1602. The Prospectus on this point reads: "Both the Kaiser Custom and the Frazer Manhattan are in the high priced automobile field. . . . The public has since the inception of production by the Corporation and is at the present time purchasing high priced automobiles in numbers much greater than was the case prior to the last war. The Corporation is, of course, not in any position to predict how long this condition will continue." Prospectus, 5.

The District Court treats this matter in its opinion at R., V, 3076–9. It concurred

The Opinion of the District Court

The Court made *findings of fact* in some thirty paragraphs. It placed considerable stress on the numerous attempts by Otis to modify the arrangements for the issue, and entered into detail in depicting the steps leading to the termination of the contract by Otis in Cleveland, reiterating that "the only ground assigned . . . was the pendency of the Masterson suit."¹⁹

Beyond these findings there were three areas in which the District Court drew important conclusions from the facts: (1) that Cyrus Eaton had determined as early as February 5, that Otis would not perform under the contract; (2) that the Masterson suit ". . . was instituted as a result of a plot to establish an excuse to breach the contract conceived by Eaton, approved by Daley, and executed by Bulkley who procured Masterson as a dummy plaintiff and Harrison who supplied Martin as the Attorney;"²⁰ (3) "that the summary of consolidated sales and earnings for the final quarter of the year 1947, set forth on page 7 of the prospectus, was computed in accordance with accepted accounting procedures."²¹

Building on these factual conclusions, the Court arrived at three *conclusions of law*: (1) Otis, by repudiation or termination, breached the contract and was liable in damages; (2) Otis may not avail itself of the Masterson suit which Otis itself collusively procured; (3) thereby caused the breach by First California and was liable therefore in damages.

The Masterson Case

The District Court, in addition to the consideration already given in its findings of fact, devoted further attention to the vexing question of the collusive nature of the shareholders' derivative action begun in

in the facts (R., V, 3067-68) but found that there had been sufficient disclosure: "It is for all these reasons we have found there was no prospect of untoward sales conditions that required revelation in the prospectus to make it honest. The prospectus truthfully described the company's sales policy and its competitive position." R., V, 3089. The brief for Kaiser-Frazer argued the question—pages 35 through 38; the brief for Otis—pages 24 through 30; in Otis' Reply Brief—pages 2 through 9.

¹⁹ Opinion of the District Court, R., V, 3062.

²⁰ Opinion of the District Court, R., V, 3065. The Court occupies itself with establishing this fact in detail through paragraphs 14 to 30 inclusive. Opinion, R., V, 3063-67.

²¹ Opinion of the District Court, R., V, 3068. The question of damages perforce occupied much of the Court's time but is *obiter* to this study, although it presents some interesting legal problems.

Detroit. The problem is fascinating, has occupied the SEC, many courts and many attorneys, but can be, and should be, pretermitted in this study.²²

The Earnings Summary in the Prospectus

Clearly a focal point in the Otis case is the question of full disclosure or misrepresentation of the earnings record on page 7 of the Prospectus. The District Court began its discussion by quoting the definition of a material fact from the rules of the Commission: Any matter "... as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."²³

The Court faced the question squarely, asserting the allegations of Otis: "Defendant complains that the summary of earnings on page 7 of the prospectus was misleading in that it indirectly showed that the earnings for December 1947, were approximately \$4,000,000.00 when as a fact, upon reallocation of the year-end adjustments, the earnings were only a little over \$600,000.00."²⁴ The Court responded to these allegations:

We have found that the summary of earnings on page 7 was not misleading but even assuming, for the purposes of discussion, that the year-end adjustments should have been reallocated to the prior months, consistency would require a complete reallocation of all elements of costs. . . . In that case, as the testimony and exhibits of Hollis indicate, the earnings of December, 1947, would have approximated \$2,865,525.00. . . . The question is reduced to a choice between two different systems of accounting. Under either the systems actually used by the plaintiff or that proposed by the defendant, if that were applied consistently to all elements of costs, the summary of earnings on page 7 of the prospectus does not distort the realities.²⁵

This was the only adversion of the District Court to this point.

The Court of Appeals

The Court of Appeals by-passed the several assigned errors and founded its decision on one point alone: Whether the District Court

²² Whereas the instant Court found that it "was proved beyond a reasonable doubt" (R., V, 3074) that the Masterson suit was instituted through Otis, and its agents, the District Court for the District of Columbia held, on substantially the same evidence, that the facts did not establish even "prima facie" that Otis had instigated the action. S.E.C. v. Harrison, 80 F. Supp. 226 (D. Ct. D.C., 1948). In such a situation the question must be treated as unsolved and the discussion proceed on that basis.

²³ SEC, General Rules and Regulations, Rule 405.

²⁴ Opinion of the District Court, R., V, 3080.

²⁵ Ibid.

was correct in finding that Kaiser-Frazer had not misrepresented, but had adequately disclosed, its profit for December? If there were such a misrepresentation, Otis was under no obligation to accept the stock and would have a complete defense to all causes of action.

Conclusions from the Facts

The Court stressed the speculative nature of the venture, the comparatively brief earnings record in the latter part of 1947, and the importance to the investor of this record as the best and perhaps only available indication of Kaiser-Frazer's ability to compete within an established industry. It noted the contention of Otis that without a favorable picture of earnings for that period the issue could not have been made. The point was that Kaiser-Frazer did determine to appraise its investors of this record, and failure to make full disclosure of all of the facts bearing on these earnings constituted a breach of the contract, and violated the Securities Act of 1933 as well.²⁶

There were nine important conclusions that were basic to the decision of the Court: (1) That although there was no December earnings figure as such, the average investor would subtract the two-months period from the fourth quarter earnings and obtain a figure of \$4,000,000.00, "which one would naturally assume to represent the profit of the Corporation for the single month of December, 1947;"²⁷ (2) That even if December earnings were not misrepresented, the fourth quarter total was excessive by \$2,245,000.00 according to Kaiser-Frazer's own calculations; (3) December earnings were nowhere near \$4,000,000.00 but about \$900,000.00; (4) The discrepancy was due simply to the inclusion in the final quarter of \$3,371,155.00 which came from an increase over book figures of the physical inventory taken in latter December, 1947; (5) This inventory increase was allocable not only to December and the last quarter, but to the entire year and even in part to prior years; (6) Kaiser-Frazer's own "Consolidated Statement of Income and Expense" bears out these conclusions:

Net Profit or (Loss) for the	
Month of December, 1947..	\$ 638,226.97
Prior Months' Adjustment	
(see notes)	3,371,155.56 ²⁸

²⁶ 195 F. 2d 838, 840 (C.A. 2d, 1952).

²⁷ Ibid., at 842.

²⁸ Ibid. See R., V, 3096.

(7) "Kaiser-Frazer's expert accountant did not deny that that inventory write-up should have been allocated to prior periods;"²⁹ (8) Even a complete reallocation of expenses charged to December, as presented by Kaiser-Frazer's expert, would still result in overstatement of December earnings in the amount of \$1,000,000.00; (9) But such a reallocation is unacceptable as opposed to the accounting system in use by Kaiser-Frazer and on which the summary was based.

On these premises the Court held that it could not agree with the District Court that the summary was prepared in accordance with accepted accounting procedures and was not misleading.

For, regardless of whether its accounting system was a sound one, Kaiser-Frazer stated its earnings in such a way as to represent that it had made a profit of about \$4,000,000.00 in December, 1947. This representation was \$3,100,000.00 short of the truth. Concededly the profits for the year as a whole were substantially unaffected by the overstatement of December earnings, but the prospective purchaser was entitled to the full disclosure of all the facts that were known to the Corporation at the time the prospectus was issued; and the Corporation knew on February 3, 1948, that its profit for the month of December 1947 was less than \$1,000,000.00.³⁰

The Court then adverted to the footnote used in explanation of the inventory adjustments and concluded that it "was entirely insufficient for this purpose. No one reading it would have been put on notice that the actual profit for December was less than a fourth of what was indicated by the table."³¹

Factually, the Court stated, there was some indication that Otis was at least informed of the actual December earnings and apparently took part in the preparation of the Registration Statement and Prospectus.³²

The Application of the Law

Onto these conclusions from the facts the Court superimposed the governing legal principles, and moved to its ultimate conclusion

²⁹ *Kaiser-Frazer v. Otis & Co.*, 195 F. 2d 838, 843 (C.A. 2d, 1952). Charles M. Hollis was vice-president and comptroller of Kaiser-Frazer at the time of the trial. The preliminary figures included in the Prospectus at page 7 were prepared under his direction. His capacity at that time was assistant comptroller. Hollis' testimony will be treated more specifically *infra*.

³⁰ "This is so regardless of the equities as between the parties for . . . the very meaning of public policy is the interest of others than the parties and that interest is not to be the mercy of the defendant alone." *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F. 2d 838, 844 (C.A. 2d, 1952).

³¹ *Ibid.*, at 843.

³² *Ibid.* The question of Otis' knowledge will receive fuller consideration *infra*.

through six well-reasoned stages: (1) the allegation is ill-founded that possible full knowledge by Otis of all the facts prior to contracting bars reliance on such facts as constituting a breach of warranty, since “. . . whatever the rules of estoppel or waiver may be in the case of an ordinary contract of sale, nevertheless it is clear that a contract which violates the laws of the United States and contravenes public policy as expressed in those laws is unenforceable;”³³ (2) further support comes from the broad language of Section 14 of the Securities Act of 1933³⁴ which brushes aside ordinary contract principles of estoppel that might otherwise apply to contracts for securities; (3) any sale to the public by the use of the Prospectus would have been a violation of Section 12(2) of the Act; (4) although the contract in itself involved only a sale to Otis, and such a sale would not violate the Act, nevertheless we “. . . are satisfied that the contract was so closely related to the performance of acts forbidden by law as to be itself illegal.”³⁵ (This was merely the initial step in the public offering that would necessarily follow.); (5) the Prospectus, found to be misleading, formed an integral part of the contract; (6) the public sale was to be made, and could only have been made, in reliance on that Prospectus (Section 5(b) of the Act).

Therefore, the Court concludes, the contract was unenforceable. Kaiser-Frazer was not entitled to recover damages, nor was Otis liable for its influence on First California.

PART II—SOLUTION

(1) Material misrepresentation and non-disclosure by Kaiser-Frazer (2) violated the duty to disclose under the Common Law, the Securities Act of 1933, and the Contract itself, (3) and, as integral to the whole underwriting agreement (4) and essentially looking to the detriment of the public investor, (5) rendered the contract illegal, and hence unenforceable, (6) notwithstanding alleged estoppel due to Otis' knowledge.

³³ Ibid.

³⁴ The Court footnotes Section 14: “Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.” 15 USCA § 77n.

³⁵ 195 F. 2d 838, 844. The Court would seem to have nodded a bit in regard to the inapplicability of the Act to sale to Otis alone. About this, *infra*.

PART III—THE LEGAL AND MORAL ANALYSIS

The thesis laid out in *Part II: Solution* will serve as a subject outline for the legal and moral commentary, will present for proof and analysis the principal sub-theses on which the total solution rests, and will trace the several steps to the ultimate adjudication: That the contract was void, and hence unenforceable.

The Question of Non-Disclosure and Misrepresentation

"(1) Material misrepresentation and non-disclosure. . . ."

From *Part II:—Solution*

In the earlier stages of the case, in the briefs before the District Court and Court of Appeals, Otis alleged two major derelictions: (1) The failure to disclose the non-recurrent profits from the Manhattan and Custom models, and (2) the non-disclosure and misrepresentation of December earnings. Confining the analysis to the December earnings,³⁰ the approach will be with three questions:— (A) Was

³⁰ A summary opinion on the question of the suppression of facts concerning the non-recurrent profits from the Manhattans and Customs would seem to indicate the following points:—(1) The District Court found that over 68% of Kaiser-Frazer profits for the five months ending November 30, 1947, were due to Manhattan and Custom sales. R., V, 3067. (2) By February, 1948, only 20% of the profits were coming from this source. R., V, 2760. (3) Contemporaneously these models accounted for 50% of all production in October and only 17% in January. R., V, 2754, 2760. (4) Kaiser-Frazer indicated its realization of the cessation of these profits by cutting projected production of these models, by planning (in October, 1947) 75% for November to (in February) 18% for February and 13% for June. R., V, 2765. (5) Meanwhile the industry as a whole could not meet the demand (R., V, 3067, 3040; IV, 2291; III, 1597), nor was there a great seasonal fluctuation (Defendant's Exhibit 139, 140). (6) No matter what Kaiser-Frazer may have expected or thought would compensate for the loss of these profits in other areas, the Prospectus should have first informed of the non-recurrence of the earnings from these models. It could have then informed the public of its hope of compensatory profits from other sources, but that was another matter. The District Court, however, accepted Kaiser-Frazer's argument and stated that no disclosure under these conditions was necessary (R., V, 3077-8). "The law is settled that no amount of honest belief that the enterprise would ultimately make money for the stockholders can excuse or justify false representations . . ." in the sale of stock. *Foshay v. United States*, 68 F. 2d 205, 210 (C.A. 8th, 1933), cert. denied, 291 U.S. 674 (1934). The undisclosed hope or belief in an alternative source of profit does not excuse a company offering securities from disclosing that its statement of past profits is largely based on non-recurring or greatly reduced sources of profits. See *Rex v. Kysant* [1932] 1 K.B. 442. Appellant's Reply Brief, United States Court of Appeals, For the Second Circuit, *Kaiser-Frazer Corporation v. Otis & Co.* As the expert witness for Otis said:—" . . . those facts, if known, would have completely negated the apparently attractive profit trend as established in the information contained on page 7 of the prospectus." Leston B. Nay, President of First Securities Company, Chicago, thirty years in the securities business, who committed his firm to participate in the selling

the alleged fact actually existent? (B) Was it concealed, or even misrepresented? (C) Was it material?

A. The Question of Fact

There is, to begin with, no dispute about the facts themselves, as such. The facts are all garnered from the books and records of Kaiser-Frazer, from the court record, or from the findings of the District Court. The first semblance of dispute comes in the analysis, the breakdown and disposition of the facts, in the conclusions, implications, imputations, and inferences latent therein.

What, then, *de facto*, was the Kaiser-Frazer earnings record? The situation through 1946 was clear. To this point Kaiser-Frazer had lost approximately \$20,000,000.00. The total figure for 1947 is also clear, a net profit of \$19,000,000.00, in spite of a \$3,000,000.00 loss in the first quarter. The focal point lies in the actual breakdown of the 1947 figures: (1) for the four quarters; (2) for the two months ended November 30, and finally; (3) for the month of December itself. For purposes of later discussion and fuller insight this last figure must be determined, in spite of allegations by Kaiser-Frazer that it did not appear in the Prospectus.

When pressed fully, there seems to be no actual dispute even about the breakdown of these figures. Kaiser-Frazer admits both the figures and the breakdowns underlying them. The District Court passed over this phase of the question and only asked whether the amounts were "material" and the representation "misleading"?³⁷ This would mean that the crucial problem was not with the fact of the figures, but with the consequent question:— Were these facts concealed? Or, if concealed, was the matter substantial and material? But the determination of these three sets of figures still remains basic to a logical elucidation of the manifold convolutions of the case.

The clarification that must be made concerns the nature and content of the three figures under question. Were these operating profits? The average investor expects to see, in a Profit and Loss capitulation, only those profits reaped from operations, and from the operations of

group of the Kaiser-Frazer stock. Testimony on Direct Examination, R., IV, 2126.

(7) This instance of non-disclosure is a strong complement to the non-disclosure of December earnings, especially since, in addition to being an instance of non-disclosure in and of itself, it does go far to explain the sharp decline of earnings in December and would logically, therefore, accompany an indication of that decline.

³⁷ Opinion of the District Court, R., V, 3080, 3081.

the period designated. The captions above each column in the Earnings Summary on page 7 of the Prospectus indicate that these figures were representative of profit based on earnings from sales. This is the usual meaning of "Sales and Miscellaneous Income," "Cost of Sales," "Selling and Administrative Expense," and "Net Profit and Loss."

There are seven main sources for the correct breakdown of these three figures: (1) the Kaiser-Frazer *Operating Report* for December 1947;³⁸ (2) the Prospectus; (3) the *Summary of Year-End Adjustments*,³⁹ (4) the *Write-Up of Inventory*, December, 1947;⁴⁰ (5) the Kaiser-Frazer *10-K Report* for 1947 filed with the SEC;⁴¹ (6) the *Schedule of Profit and Loss After Redistribution*,⁴² (7) the *Allocation of Prior Months' Adjustments*.⁴³

The Kaiser-Frazer *Operating Report* gives the base for the breakdown by separating operating profits from write-ups allocable to other months:

Net Profit or (Loss) for the	
Month of December, 1947 . . . \$	638,226.97
Prior Months' Adjustments . . .	3,371,155.56

This report was prepared by Kaiser-Frazer officials for use by Kaiser-Frazer officials.

These *Prior Months' Adjustments* are then summarized by Hollis, expert accountant witness for Kaiser-Frazer, in the *Summary of Year-End Adjustments*:

³⁸ Kaiser-Frazer Corporation, Consolidated Statement of Income and Expense (not audited) For the Month of December, 1947, Exhibit D to Defendant's Exhibit 76, R., IV, 2276. See Index, R., VI, XXVI.

³⁹ Summary of Year-End Adjustments, Kaiser-Frazer Corporation and Subsidiaries, December 31, 1947, Plaintiff's Exhibit 97, R., V, 2611.

⁴⁰ Write-up of Inventory as of December 31, 1947, Included in Preliminary Figures Used in Prospectus, Defendant's Exhibit 63, R., V, 2800. This exhibit was prepared by Harry M. Prevo, expert accountant witness for Otis, a certified public accountant for 25 years, partner of White, Bower & Prevo, Chairman of the Michigan State Board of Accountancy. Prevo's firm began an inspection of Kaiser-Frazer books in February, 1949. R., III, 1241, 2.

⁴¹ Form 10-K For Corporations, Kaiser-Frazer Corporation, File 1-3340-2, Docket Section, Securities and Exchange Commission, Washington, D.C.

⁴² Schedule of Net Profit or Loss by Periods After Giving Effect to Redistribution of Prior Month's Adjustments and Other Costs and Expenses Recorded in November, 1947, and December, 1947, to the Periods to Which They Apply, Plaintiff's Exhibit 98, R., V, 2613.

⁴³ Kaiser-Frazer Corporation, Allocation of Prior Months' Adjustments Included in December, 1947, and Related Data, Defendant's Exhibit 81, R., V, 2818.

SUMMARY OF YEAR-END ADJUSTMENTS
KAISER-FRAZER CORPORATION AND SUBSIDIARIES

December 31, 1947

Profit for eleven months ended November 30, 1947, as per financial statements included in registration statement		\$15,495,748.27
Addition for December before year-end adjustments		638,226.97
Year-end adjustments:		
Inventory:		
Difference between physical inventories and book inventories prior to pricing adjustments	\$2,195,808.73	
Inventory shrinkage reserves not required	1,552,481.43	
Repricing to reflect revised standard costs	614,656.33	
Repricing of sheet steel	325,207.32	
Repricing of labor and burden	164,415.91	4,852,569.72
Vacation pay		100,692.09
Overriding discounts	\$ 120,000.00	
Factory warranty and policy adjustments	780,202.93	
Cost variances on steel slabs furnished to rolling mills by Portsmouth Steel Corporation	207,599.93	
Bonus to nonunion employees . .	332,173.53	
Miscellaneous adjustments, each less than \$100,000.00	142,129.86	
	<u>\$1,582,106.25</u>	<u>\$21,087,237.05</u>
		1,582,106.25
Profits for twelve months ended December 31, 1947, as per registration statement		<u>\$19,505,130.80⁴⁴</u>

This summary again isolates the operating profit for December at \$638,226.97 and the adjustment figure for prior months at \$3,371,155.56. But it does more. It begins to explain what footnote 4 on page 7 means when it says: “. . . reflects various substantial year end adjustments including provision for certain reserves and a material in-

⁴⁴ Since the figure for the year ended, *after audit adjustments*, comes to substantially the same figure (\$19,015,677.96) reproduction of adjustments has been omitted from the above summary.

crease in inventories. . .” The figure of \$1,582,106.25 is the total of those year-end adjustments, the reserves, which operated to *reduce* the total of December earnings. Subtracting this figure from the inventory adjustments, plus vacation pay (\$4,852,569.72), gives the net years-end adjustment (\$3,371,155.56) which was added as an increase to the operating profit (\$638,226.97). When this was added to the eleven months ended November 30, 1947 (\$15,595,748.27), the result was the total profit for the year (\$19,505,130.80). These figures, taken from the Kaiser-Frazer exhibit (and hence uncontroverted by them) advance the breakdown considerably and leave only further identification of the five figures listed under the inventory adjustments and totaling \$4,852,569.72.

The Inventory Write-Up

The three repricing figures are self-explanatory and simply write-ups of inventory based on higher values due to (1) standard costs, \$614,656.33; (2) increased value of sheet steel, \$325,207.32; and (3) labor and burden, \$164,415.91.⁴⁵ These totalled \$1.1 million.

A study of the Prospectus in comparison with the Kaiser-Frazer *Form 10-K* (for the year 1947) explains the figure of inventory shrinkage. On page 24 of the Prospectus the Consolidated Balance Sheet for June 30, 1947, shows under Inventories a reserve of \$955,264.89 for possible shrinkage. On page 26 the Consolidated Balance Sheet for November 30, 1947, shows this reserve at \$1,553,808.04. The Prospectus did not give the Balance Sheet for December, 1947, but reference to the 10-K Report gives the audited figures filed with the Commission at year-end. In the *10-K Report* the \$1.5 million inventory reserve is missing. Comparison of the capitulation of inventory Note B of the Prospectus at page 30 with the exactly corresponding information in *Form 10-K*, at page F-6, shows no reserve at all for shrinkage, one month after the figures in the Prospectus.

In tracing down this inventory shrinkage figure after its disappearance in the month between the Prospectus and the official and audited *10-K Report*, the three possible destinations all indicate that this is the figure appearing in the year-end adjustments under Profits. There is no evidence that this reserve was (1) put into Surplus, as a check of

⁴⁵ Recourse to the *Write-up of Inventory* prepared by Prevo shows that the \$614,656.33 was a write-up resulting from valuing the inventory (in contradistinction to merely re-counting the inventory) at 1949 standard prices rather than 1947 standard prices. The figure of \$299,624.71 was a 30% markup in value of the steel content of inventory. R., V, 2800, see note 40 supra.

page F-5 of the *10-K Report* will show, (2) returned to any balance sheet reserve accounts (page F-3), or (3) netted against the inventory total shown in the December balance (had it been so done, it would have appeared as it did in November and June, or should have been so shown). There was, moreover, no footnote in the 10-K Balance Sheet notes indicating where the \$1.5 million went.⁴⁶ In short, if it did not go into Profit and Loss, it had to appear elsewhere, but does not. There seems little doubt, therefore, that the reserve set up over the year 1947 for inventory shrinkage was lumped into Profits and appeared in the following totals in the Prospectus: (1) The year ended December 31, 1947; (2) The quarter ended December 31, 1947. But, and this is clearly as important as the figures in which this amount did appear, it was *not* contained in any form, allocated or otherwise; (1) in the first three quarters; (2) in the two months ended November 30, 1947; (3) in the eleven months ended November 30, 1947.

This leaves one remaining figure unaccounted for, the \$2,195,-808.73 difference between physical and book inventory. The only explanation for such a figure is a straight write-up of inventory amount, based not on increased value, but on the physical recount set against the book figure. This fills out the \$3.37 million over and above profits from operation.

The Actual Earnings from Operations

The reasoning thus far has led to the conclusion that the \$4,000,-000.00 differential between the eleven months ended November, and the year ended December, as shown in the Prospectus, consisted of two elements: (1) \$638,000.00 in operating profits, and (2) \$3.3 million inventory write-ups. The question now is this:— Where does this \$3.3 million truthfully belong? Part of the answer has already been indicated in the reference to the fact that the Consolidated Balance Sheets for June 30, 1947, and again for November 30, 1947, in the *10-K Report* showed the gradual growth of the reserve for possible inventory shrinkage. This growth would partially indicate the proration for that segment of the total inventory write-up figure. But the full answer must come from accountant experts who have studied the Kaiser-Frazer books. Both Hollis for Kaiser-Frazer and Prevo for Otis submitted schedules of distribution of the inventory write-ups lumped into the fourth quarter.

⁴⁶ Form 10-K For Corporations, at page F-6. See note 41 *supra*.

Hollis, in his *Schedule of Profit or Loss After Redistribution*, made a redistribution of the \$3.3 million Prior Months' Adjustments, showing the net profit by months as follows:

September	\$4,500,000
October	6,100,000
November	4,100,000
December	863,000

These figures were submitted by Hollis in his attempt to prove another point in the Kaiser-Frazer argument,⁴⁷ but it is to be noted here that this information gained *ex aliunde* clearly shows that Hollis and Kaiser-Frazer realized that the inventory write-ups should have been allocated to the months in which they actually reduced the cost of sales and hence increased the earnings from operations.⁴⁸ Hollis allocated the amount of \$225,394.45 to the operating profits of \$638,226.97. This figure is approximately the same as Prevo used in his *Allocation of Prior Months' Adjustments*. Prevo produced the following monthly capitulation of profits after distribution of the \$3.3 million:

September	\$4,400,000
October	6,100,000
November	4,000,000
December	900,000

Comparison of this schedule with that of Hollis leaves little doubt about the approximate proration, or, more important, the reasonableness of proration itself.

It must be said very clearly, as Prevo admitted, that there is no complete information as to exactly the correct redistribution of the inventory write-ups. "We didn't get there until over a year after the inventory was taken."⁴⁹ This, of course, was not true of Hollis.⁵⁰

⁴⁷ Hollis submitted a completely alternative plan in explanation of the December earnings figure of \$4 million, not by way of explaining what actually appeared in the Prospectus, nor of justifying the Summary of Earnings, but in order to show that if another, and completely different, approach to the whole accounting situation had been used, the result would have still been to list December "earnings" at about the same figure. However, it remained as the Circuit Court says, that "... the amount of the overstatement of December earnings was ... over \$1,000,000.00." 195 F. 2d 838, 843 (C.A. 2d, 1952).

⁴⁸ The allocation of inventory increase should be reduced to a per-car basis over the proper period and December be given credit on the basis of cars shipped during that month.

⁴⁹ Prevo, on direct examination, R., III, 1300.

⁵⁰ Hollis on cross examination said of these figures in his *Schedule*: "That is the adjustment of the proper period for the amount of prior months' adjustments re-

The Earnings by Months and Quarters

The point has come where the factual question posed at the outset can be answered. The books of Kaiser-Frazer, the *10-K Report*, the records of the Court, and the expert testimony of both accountants have provided the figures for a general capitulation supplying the actual breakdown of 1947 figures: (1) for the four quarters, (2) for the two months ended November 30, (3) for the month of December itself. These figures are in complete pr  scission from the question of what was or was not actually disclosed in the Prospectus. This is a factual inquiry designed only to clear the air and ground for a consideration of the two remaining questions:— (1) Were the facts concealed? Or even misrepresented? and, (2) Were they material?

Using a composite of the schedules of Hollis (*Schedule of Profit and Loss after Distribution*)⁵¹ and Prevo (*Allocation of Prior Months' Adjustments*),⁵² the table on the next page represents the actual earnings from operations for the various periods, *after* reallocation of the \$4,000,000.00 inventory write-up.

B. The Question of Disclosure

There seems to be little doubt about the actual earnings of Kaiser-Frazer during this period. There might be variations, insignificant in amount, but the general totals all lead to the same conclusion. The question then is: How should these facts of earnings be disclosed to

corded in the month of December, 1947." R., III, 1797. Hollis did not contradict Prevo but attempted to offset his redistribution of inventory write-ups in his *alternative* explanation by concomitant reallocation of (1) Advertising Expenses, (2) Steel Variances and (3) Miscellaneous Expenses. Hollis' final figure with this completely new set of redistributions is \$2.8 million profit for December. It is not said why these figures were not actually used in the Prospectus if they were correct, nor how, if being correct, they could justify the incorrect figures actually used, for public consumption. As supplementary to this reasoning the Circuit Court rejected Hollis' hypothesis on the grounds that: (1) The accounting procedure of reallocation was opposed to the system actually used by Kaiser-Frazer (which is probably the reason, in the beginning, why it was not actually used in preparing the Prospectus), and (2) on which the Summary was based. 195 F. 2d 838 at 843. The steel variances in the amount of \$1,000,000.00 were traditionally written off in the month in which the steel was purchased and in which the gray-market loss was sustained, and not, as Hollis would do, in the month in which the steel was used. Advertising expenses were improperly allocated, since there was December advertising of \$758,000.00 which was not included in December in the Prospectus figures, so the result of removing *November* advertising left December without any expense at all, which obviously was not the case. In general, then, Hollis' hypothetical reallocation served only one good purpose, that of revealing his true mind on the matter of redistribution of inventory write-ups lumped in December. His attempt at a collateral and alternative explanation was abortive.

⁵¹ See note 42 *supra*.

⁵² See note 43 *supra*.

the investor public? (1) Were the facts concealed from the investor in the Prospectus? (2) Were they even misrepresented?

These questions will be treated *per modum unius*. There are five areas of inquiry: (1) the earnings record for the year *in toto*, (2) the first three quarters, (3) the fourth quarter alone, (4) the two months ended November, (5) the month of December alone.

The Kaiser-Frazer argument has two major approaches:— (1) "The earnings statement was proper in all respects."⁵³ (2) The accounting methods were acceptable. Under these two headings fall most of the Kaiser-Frazer allegations.

Period	Net Profit or Loss*
From August 9 to December 31, 1945.....	\$ 700,000*
Year ended December 31, 1946.....	19,000,000*
Eleven months ended November 30, 1947.....	18,200,000
Quarter ended March 31, 1947.....	2,900,000*
Quarter ended June 30, 1947.....	1,700,000
Quarter ended September 30, 1947.....	9,300,000
Quarter ended December 31, 1947.....	11,100,000
Two months ended November 30, 1947.....	10,200,000
Month ended December 31, 1947.....	900,000
Quarter ended December 31, 1947.....	11,100,000
Year ended December 31, 1947.....	19,100,000
Month ended September 30, 1947.....	4,500,000
Month ended October 31, 1947.....	6,100,000
Month ended November 30, 1947.....	4,100,000
Month ended December 31, 1947.....	900,000

The Earnings Summary in the Prospectus

The focal point is the month of December. To this Kaiser-Frazer answers: "There was no separate statement in the Prospectus as to the amount of December earnings."⁵⁴ Therefore there could be nothing misleading in that particular. Implicit in this, moreover, is the assumption that the average investor reading the Prospectus would not subtract the \$9,000,000.00 for the two months ended November from the figure of \$13,000,000.00 immediately below it in order to ascertain the December earnings. Kaiser-Frazer says it is a "fallacy" to

⁵³ Appellee's Brief, United States Court of Appeals for the Second Circuit, Kaiser-Frazer Corporation v. Otis, page 39.

⁵⁴ Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit, Supreme Court of the United States, Kaiser-Frazer Corporation v. Otis, at page 14.

assume "that the investor would have made the arithmetical calculations."⁵⁵

Kaiser-Frazer explains the arrangement of earnings figures in the Prospectus as a buildup dictated by the temporal exigencies involved in adding the later and amended figures to the set appearing in the Prospectus as it was filed anticipatory on the issue for January. At the time of the earlier filing, December profits were not known, hence earnings were shown only through the eleven months. Thus, logically, the first three quarters were given, and, of necessity, the two months, period ended November. Then came the postponement of the issue. On amendment, the fourth quarter was added, and the year, but the original eleven months' figures and the two months ended November were left intact "because the unaudited balance sheet in the Prospectus was as of that date" and "the SEC requires this."⁵⁶ This growth is advanced to explain the pattern in the Prospectus, the separating asterisks, and the figures to November 30 and not year-end.

The more correct reasoning, it is submitted, would indicate: (1) that although the \$19,000,000.00 figure for the year was substantially correct, nonetheless there was even some of that amount that should have been allocated to the year previous; (2) that certainly the figure of \$13,000,000.00 for the fourth quarter was not merely a case of non-disclosure but a positive misrepresentation, being approximately \$2.3 million in excess, since the profit from operations (and that was what the captions in the Prospectus indicated) was not \$13,000,000.00 but \$11,000,000.00 according to both Prevo and Hollis; (3) that the average investor, as the Court of Appeals concluded, would immediately subtract the two months from the fourth quarter and be misled into believing that (a) this was profit from operations and for December alone, and (b) that it was \$4,000,000.00, and not \$900,000.00. (If this were not done, there was a second excellent opportunity to be misled in the same manner by subtracting the eleven months from the figure for the year); (4) that there was no valid reason, accounting-wise, for not listing December earnings in isolation, or, for that matter, monthly earnings over the last two quarters, since the recent earnings record was so brief and so important.

Refer at this point to Rule 421(a) of the General Rules and Regulations of the Securities and Exchange Commission under the

⁵⁵ Appellee's Brief, 56, see note 53 *supra*. Such a claim seems to admit in some way that if the subtraction were made the result would be deception.

⁵⁶ *Ibid.*, at 39.

Securities Act of 1933, as amended. The Prospectus may not be arranged "in such fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading."⁵⁷ The law interpreting this point has been clear. Even though it may be true that all the relevant data is presented in the Prospectus, the disposition of the figures, the juxtaposition of one figure against another, the typography and general arrangement may make the total impression misleading.⁵⁸

The Prospectus further concealed the fact that November earnings were off by almost \$2,000,000.00 from October. In short, there was no way of knowing that the earnings graph would show the following downgrade:⁵⁹

September	\$4,500,000
October	6,100,000
November	4,000,000
December	900,000

The earnings record, so important and relevant to an informed and intelligent analysis of the future prospects of the company, was not disclosed and was even positively misrepresented.

The Accounting Methods

To all this Kaiser-Frazer replies that: "Clearly, the prospective investor was put on notice that 'substantial adjustments,' including 'a material increase for inventories,' has been made."⁶⁰ Reference was also made to other cautionary phrases. It was "... tentative information ... without audit ... on the basis of a preliminary closing. ..."⁶¹ In general it is argued that the whole tenor of the Prospectus, especially footnote 4 on page 7, would give the reader indication of the nature of the figures.

⁵⁷ General Rules and Regulations Securities and Exchange Commission, Rule 421(a).

⁵⁸ National Educators Mutual Ass'n, 1 S. E. C. 208, 215 (1935). There is pertinency also in the following: "This has been the case not only where untrue statements made at one point have been sought to be cured by subsequent contradictions elsewhere ... but also in situations where the failure to limit or qualify an inexact statement at the very point where it was made was held to render the prospectus deficient, notwithstanding the statement was susceptible of correction from information supplied elsewhere in the prospectus." *Income Estates of America*, 2 S. E. C. 434, 441 et seq. (1937).

⁵⁹ This is a composite of the Hollis and Prevo figures. See notes 42 and 43 supra.

⁶⁰ Petition for Writ of Certiorari, 20, see note 54 supra.

⁶¹ Prospectus, page 7.

Again, there seems to be little support for the contention that the footnote actually used in the Prospectus revealed the true state of the earnings record, either in regard to the drop-off in operating profits or the inventory write-ups. Rather cogent evidence of the insufficiency of the footnote is provided in the expert testimony of L. B. Nay, president of a Chicago investment firm. Mr. Nay relied on the statements in the Prospectus and committed his firm to the selling group. The extent to which he felt he had been informed can be readily deduced from his reaction on reception of all the facts. He was asked what he would have done had this information been disclosed to him from the beginning.

That . . . would have made it completely impossible for me to consider the recommendation . . . of these securities; and . . . would have further resulted in my recommendations to those investors who already owned shares . . . to dispose of them.⁶²

It could hardly be said that Mr. Nay felt he had full disclosure in the Prospectus.

There is further indication of the efficacy of this footnote in the history of its draft. On January 20, 1948, seven days before submission of the final footnote, the Touche-Niven accountant in charge of the preparation and drafting of the Registration Statement and Prospectus received word of the tentative year figures from Kaiser-Frazer; and "the indicated earnings for the 12 months before year-end adjustments were only some three or five hundred thousand dollars above the figures shown in the registration statement on page 7 of the Prospectus for the 11 months."⁶³ After extended discussion on the matter the Touche-Niven accountant drafted the following tentative footnote for the Prospectus:

Preliminary and tentative estimates as to the result of operation for December, 1947, and as to possible year-end adjustments (other than adjustments affecting inventory) indicate that profits for the 12 months period ending December 31, 1947, may not be materially in excess of the amount shown for the eleven months ended November 30, 1947.⁶⁴

⁶² Leston B. Nay, President of First Securities Company, Chicago, Direct Examination, R., IV, 2128.

⁶³ William W. Wertz, partner in the firm of Touche, Niven, Bailey & Smart, Direct Examination, R., III, 1548. See Defendant's Exhibit 90, R., V, 2832 for notation of amendment of Registration Statement, dated January 27, 1948.

⁶⁴ Wertz Handwritten Draft of Footnote to page 7 of Prospectus, Defendant's Exhibit 106, R., V, 2862. Typewritten Draft, Defendant's Exhibit 107, R., V, 2864. For comments by Wertz on direct examination, R., III, 1548, 9; 1551.

This draft, which would have put a reader on notice, was not used. Whether the footnote was rejected at the instance of Kaiser-Frazer or Touche-Niven, or both, is not exactly relevant to this analysis, but the fact of the consideration and rejection would seem to impugn somewhat the Kaiser-Frazer statement that, "This calculation of earnings . . . had been approved by the independent public accountants of Kaiser-Frazer who had participated in the drafting of the footnote, which the Court of Appeals found to be inadequate."⁶⁵ The other independent firm of accountants, White, Bower & Prevo, reported through Prevo:

This note conveys no concept of the enormity of the write-up, or that, in disregard of the Company's own reports, the entire sum of \$4,403,854 was included in the profits for December.⁶⁶

No *positive* misrepresentation can seemingly be imputed to the footnote, although one element does seem to exceed mere non-disclosure. Inspection of the evolution of the phraseology of the footnote indicates the possibility of positive deception. As first drafted it read:—

4) The tentative information for the quarter and year ended December 31, 1947, reflects year end adjustments including a material increase in inventories to conform to the results of a complete physical inventory taken by the Corporation as of December 31, 1947.⁶⁷

This typewritten form was corrected by hand with two additions: (1) the words "various substantial" were inserted after "reflects," and (2) "provision for certain reserves and" were placed after "including." Certainly there is warranted aversion to the fact that provisions for reserves invariably indicate *decreases* in earnings (unless out of surplus), whereas the increase in inventory *increases* the earnings. An investor could be expected to conclude that these items, without more indication or details to the contrary, set up as they were in the Prospectus tended to offset each other and leave the earnings record substantially intact and representative of profits from operations.

In this connection Kaiser-Frazer's statement that "The earnings statement and footnote became part of the Registration Statement which the Securities and Exchange Commission permitted to become

⁶⁵ Petition for Writ of Certiorari, 15, see note 54 *supra*.

⁶⁶ Affidavit of Harry M. Prevo in Support of Motion, District Court of the United States, For the Southern District of New York, July 20, 1949; R., I, 133.

⁶⁷ Amendment of Footnote 4 of the Prospectus, Defendant's Exhibit 96, R., V, 2844. Comments by Wertz concerning his part in the rephrasing are at R., IV, 2271-2.

effective,"⁶⁸ is misleading on two counts. First, the SEC cannot and does not pass on the accuracy or adequacy of the Prospectus,⁶⁹ and second, Kaiser-Frazer ignores the very important fact that Otis made every attempt in the District Court, but was overruled, to introduce evidence that the accountants for the SEC had not been informed of the true nature of the earnings figures in the Prospectus, but were deceived as to the total status of Kaiser-Frazer.⁷⁰ The District Court made no comment on the footnote.

The nub of the question of disclosure and misrepresentation is a simple one: Did the Prospectus actually reveal the true state of earnings? Another way to put this same question is to ask: Were the accounting methods proper? Accounting methods, in this context, are designed for only one purpose, to tell the true story in conventionalized figures and schedules. When Kaiser-Frazer says that accounting methods were proper this is what is meant. Looking down from bird's-eye on the whole problem of disclosure and the accounting methods used to effect this disclosure, what is the summary status of the problem?

The Otis expert accountant contemned the methods employed by Kaiser-Frazer in disclosing the true status of the company. Hollis, Kaiser-Frazer's expert, made no direct rebuttal or denial of this statement. Hollis by-passed a direct clash with Prevo and testified that even supposing the figures actually used were wrong, they were not wrong in end result, because if a proper reallocation had been effected, the profits for December would still have been \$2.8 million, (which would have been over \$1,000,000.00 in excess of the actual profits) and so no one would have been misled by very much.

Kaiser-Frazer is insistent on the point that the methods and figures that it actually endorses are the ones actually used in the Prospectus. It states that it brought forward the second set of figures only in an effort to show that the accounting methods advocated by Otis (which consisted chiefly in the allocation of the inventory write-ups to the

⁶⁸ Petition for Writ of Certiorari, 15, see note 54 *supra*.

⁶⁹ The order of the SEC making any registration statement effective is in no way approval. Section 23 of the Act makes it unlawful to represent to any investor that the S. E. C. has in any way passed on the merits or even that the Commission has found that the registration statement is complete or accurate. Pursuant to Rule 425, the Kaiser-Frazer Prospectus carried the following on the first page: "These securities have not been approved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of this prospectus." See: *Oklahoma-Texas Trust v. S. E. C.*, 100 F. 2d 888 (C.A. 10th, 1939).

⁷⁰ R., III, 1561-63; 1616-19.

prior months), *if properly employed*, resulted in a total December earnings of \$2.8 million, which was not far from the figures resulting from the methods employed by Kaiser-Frazer, which showed earnings for December at \$4,009,382.53.⁷¹

The conclusion to the question would seem to be this: (1) If Kaiser-Frazer is prepared to stand by the methods actually employed, there is little evidence in favor of accounting procedures that disclose so little and misrepresent so much. (2) Why was there no attack on the methods advanced by Prevo, which carry with them a basic logic that seems irrefutable?⁷² (3) Were it to be assumed, *ex arguendo*, that the second set of figures advanced by Hollis were correct, the bald fact is that the Prospectus nonetheless carried the false figures; and (4) Another set of figures, albeit correct, does not remedy the original incorrect set (if 2 and 2 are 4, the public wants to see it that way, not 3 and 3 are 4.); (5) But even the second set of figures are not acceptable because they do not reflect the actual state of affairs and are inconsistent with Kaiser-Frazer's accounting system,—the system used in preparing the figures in the Prospectus.⁷³

Accepted Accounting Principles

Undoubtedly the ultimate norm in determining the propriety of the accounting methods actually employed by Kaiser-Frazer and

⁷¹ After Hollis had made the redistribution of the inventory write-ups which he had, in his presentation of the figures in the Prospectus, placed in December, he went back over the books and found various sums in other months that rightfully belonged in December. (See notes 47 and 50 *supra*, and corresponding sections in body.) With these adjustments Hollis arrived at the following monthly profit figures:

September	\$4,500,000
October	5,500,000
November	4,000,000
December	2,800,000

See: Schedule of Profit and Loss by Periods, Schedule 1, note 42 *supra*. These figures were effected chiefly by adjustments of advertising expense, miscellaneous expense and steel variances. These allocations were discussed fully in note 50 *supra* and rejected by the Circuit Court for the reasons already noted.

⁷² Harry M. Prevo, *Direct Testimony*, R., III, 1307 et seq. This has excellent probative force.

⁷³ Kaiser-Frazer stresses this in *Petition for Writ of Certiorari*, *passim* 15, note 54 *supra*. It is submitted that Kaiser-Frazer showed considerable vagueness and confusion in its stand on the accounting practices. In proceeding through the record it is not clear, whether Kaiser-Frazer is going to stand with its methods and figures in the Prospectus or whether the new set submitted by Hollis is an alternative. Thus it is understandable, if true, as Kaiser-Frazer states: "Thus the Court of Appeals misinterpreted the findings of the District Court on this important issue of fact and misunderstood the purpose and effect of the evidence . . ." *Petition for Writ of Certiorari*, 16, see note 54 *supra*. This same misunderstanding is reflected consciously in the unfolding of this issue in these pages.

Touche, Niven is a close study of the true facts held up against the published Prospectus. In other words it is an *ad hoc* matter. This does not mean that some further insight cannot be gained by a very brief résumé of the pertinent accounting principles applicable in the instant problem. This résumé, therefore, will be made.

The SEC has been very explicit in its statement of the practice to be followed in presenting full facts about unusual items, such as non-recurring increment, in the earnings summary. *Accounting Series Release No. 62* is exactly to the point:

In order that investors may make proper use of the summary earnings table and to prevent the possibility of misleading inferences, certain explanatory data are usually necessary. If, for example, the reported earnings reflect the results of unusual conditions, or in certain years include significant non-recurring items of income or expenses, an appropriate disclosure of such conditions or items is made either in the summary or in the footnotes thereto.⁷⁴

The extreme importance of the actual earnings record as an indication to the investor of the future of the firm is expressed in some detail in *Accounting Release No. 53*. The same stress on full disclosure of non-recurring items is also made.

In reaching a judgment as to the future prospects of a company it is customary to begin with a statement of actual operations for an appropriate past period. . . . In general, what is done is to segregate and earmark what are considered to be unusual and nonrecurring items of income, expense and loss so that the reader will be warned of them and so may arrive at a conclusion as to whether such items can be expected to recur. In addition, special treatment is accorded items of income or loss or expense that have been reported in the financial statements of one year, say 1943, but which by reason of later events or knowledge, are now known to have been actually part of the costs or revenues applicable to another year, say 1942. In such cases, it is customary . . . to include such items in the year to which they are now known to be related.⁷⁵

This would seem to be justifiably related to the unallocated inventory in the Kaiser-Frazer Prospectus. Later in the *Release* the SEC states that "the items included therein should clearly and accurately reflect only actual operations."⁷⁶

The seventh edition of Montgomery's *Auditing* lays down the principle very clearly:

Surplus adjustments, material in amount, have occurred frequently in practice, and . . . when they affect the income of any period included in the registration statement . . . earnings summary . . . the best practice is to restate the income accounts of prior years. Recasting may also be required in respect

⁷⁴ SEC, Accounting Series Releases, Release No. 62, at page 194 (1948).

⁷⁵ SEC, Release No. 53, at page 145.

⁷⁶ SEC, Release No. 53, at page 148.

of reserves provided in prior years for costs or losses which were materially different from the provisions therefor. . . . Notwithstanding that this results in net income different from that previously reported, the guiding objective should be to make a fair presentation in the light of information obtained since the earlier statements were issued.⁷⁷

At another point Montgomery's *Auditing* touches very close to the Otis situation:

When an income statement is submitted for an interim period of less than one year and there is reason to believe that the income and expenses for the interim period may not be indicative of the rate of yearly earnings because of seasonal variations or for other reasons, it is essential that a footnote to that effect be appended. The need for this precautionary note should also be considered in connection with the summary of earnings in the narrative section of the prospectus.⁷⁸

C. The Question of Materiality

In the deductive process the difficulty generally does not lie in the ascertainment of the general principles applicable, but in the application of the principles to the instant facts. So it is in the question of materiality. Fortunately, here, the norms for determination are clear, and their expression frequent. Even more fortunately, the instant facts, held up for application to the general principles, leave little doubt about materiality. First the norm, then the application.

The Principle Applicable

In the most general terms the Restatement of Torts has crystallized the definition of materiality: A fact is material if "its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his course of action in the transaction in question."⁷⁹ The Restatement adds that a fact is material if "the maker of the representation knows that its recipient is likely to regard the fact as important although a reasonable man would not so regard it."⁸⁰ This last concept is important, and received fuller elaboration in connection with the courts' interpretation of the securities laws. Reliance cannot be placed on the norm of "a person of ordinary business intelligence," since the securities laws "were enacted for the very purpose of protecting those who lack business acumen."⁸¹ In other

⁷⁷ Montgomery's *Auditing* (Seventh Ed., 1949) 519.

⁷⁸ *Ibid.*, at 519, 520.

⁷⁹ Rest. Torts, § 538 (2) (1938).

⁸⁰ *Ibid.*

⁸¹ *United States v. Monjar*, 47 Fed. Supp. 421, 425 (D.C. Del., 1942), *aff'd* 147 F. 2d 916 (C.A. 3d, 1944), cert. denied, 325 U.S. 859; See also: *S. E. C. v. Timetrust, Inc.*,

words, "the monumental credulity of the victim is no shield for the accused."⁸² This does not mean that the Prospectus must "state every fact about a stock offered that a prospective purchaser might like to know or that might, if known, tend to influence his decision."⁸³ But it does prohibit half-truths,⁸⁴ and requires such disclosure as the Commission has stipulated in its definition of materiality: The information demanded is confined "to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."⁸⁵ The District Court quoted this Commission rule.⁸⁶ A material fact has also been defined as one "which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question."⁸⁷

Keeping these principles in mind, the question is: Were the facts, not disclosed and even misrepresented, material? The question could even be better put in the words of the Commission: Was the following verified in Kaiser-Frazer's Prospectus?

On a consideration of this record as a whole, the cumulative effect of these deficiencies is such that the registration statement and the prospectus do not adequately reflect the information necessary for an intelligent understanding of the business in which the prospective purchaser of the securities registered is asked to invest his money.⁸⁸

Such a general norm takes the question up to a broader plane and removes the issue from one or more isolated instances of non-dis-

28 Fed. Supp. 34, 42, 43, 1 S. E. C. Jud. Dec. 737 (N.D. Cal., 1939); *Rex v. Johnston* (1932), O.R. 79, 57 C.C.C. 132 (1932) 1 D.L.R. 655 (Can. Cr. Code § 414).

⁸² *Deaver v. United States*, 155 F. 2d 740, 744, 745 (App. D.C., 1946), cert. denied 329 U.S. 766. But, see: *S. E. C. v. Gold Hub Mines Co.*, 1 S. E. C. Jud. Dec. 634, 635 (D.C. Colo., 1939).

⁸³ *Otis & Co. v. S. E. C.*, 106 F. 2d 579, 582 (C.A. 6th, 1939), 1 S. E. C. Jud. Dec. 790.

⁸⁴ As Lord Macnaghten phrased it: "... everybody knows that sometimes half a truth is no better than a downright falsehood." *Rex v. Kyslant*, [1932] 1 K.B. 442. See also: *Hughes v. S. E. C.*, 174 F. 2d 969, 976 (App. D.C., 1949); *Equitable Co. v. Halsey, Stuart & Co.*, 312 U.S. 410, 425, 426.

⁸⁵ General Rules and Regulations under the Securities Act of 1933, as amended, Securities and Exchange Commission, Rule 405. The same general language was found in The Lord Davey Report of 1895, one of the reports on English Company Law reform: "... every contract or fact is material which would influence the judgment of a prudent investor in determining whether he would subscribe for the shares or debentures offered by the prospectus." Cmd. 7770 (1895) § 14(5); also see *Macleay v. Tait*, [1906] A.C. 24.

⁸⁶ Opinion of the District Court, R., V, 3076.

⁸⁷ *Charles A. Howard*, 1 S. E. C. 6, 8, 18 F.T.C. 626 (1934).

⁸⁸ *Mutual Industrial Bankers, Inc.*, 1 S. E. C. 208, 215 (1935).

closure and misrepresentation. Was the Prospectus *in overall* such as to reveal the true state and full picture?

The Principles Applied

The central issue in the question of the materiality of the non-disclosure and misrepresentation of the Earning Summary in the Prospectus has six distinct elements: The importance to the investor of (1) the recent (2) upward (3) trend (4) of substantial increment (5) from operating profits, (6) not from revaluation, recount of inventory or absorption of reserve. In the *Otis* case the complexus of these elements spells materiality.

(1) The Kaiser-Frazer Corporation had been in business for a brief period. Its earnings record was even briefer. There was only the shortest span of time to which an investor could look, the six or seven months immediately preceding the issue. For the investor to be denied the information for the very last month, or to have the recent months grouped with the earlier without the ability to extract the more recent, was a material deprivation of information. The only adequate presentation of the recent record was month-by-month. Were the company long in business, with many years behind it, established in the field, then perhaps a year-by-year presentation would be in order. But here was a firm attempting to break into an ironclad field, only a few months out of the red. For it, months were the only evidence and the only periods that could tell anything.

It is clear that the (2) *upward* nature of earnings record was essential. As portrayed in the Prospectus the profits were *up*. In fact, for the months of *November* and *December* they were *down*. This, to say the least, is material. When the downward element is combined with evidences of a (3) *trend*, further materiality is present. Had the graph of earnings been up and then down, and, at the moment of the issue, down, it would have been one thing. But it was another that the earnings had been heading down in a trend from \$6,000,000.00 in October, to \$4,000,000.00 in November and \$900,000.00 in December. An investor might well conclude, especially in the face of the well-known sellers' market that he was seeing all around him in the latter months of 1947, that Kaiser-Frazer had exhausted itself by October and was on the way down. This downward trend was concealed. In fact every indication pointed to a trend in the opposite direction.

Determination of how (4) *substantial* an increment is involved can

be premised on several fundamentals,—percentage of return on capital, ratio of sales to total assets, or to net worth, net income per share of common stock, and so on. Or a less technical comparison can be made between recent profit trends and prior losses. By any of these norms, the amounts involved in the Kaiser-Frazer suppression were substantial, and hence highly material to an investor. The sum in question was \$3.1 million. Perhaps the first sign of the magnitude of this amount is the disastrous effect its subtraction would have on the earnings record. Probably the next thing a competent layman would do would be to consider its effect on the overall financial status of the company. It is only by the write-up of \$3.1 million that the losses roughly amounting to \$19,000,000.00 for 1946 can be offset by the profits for 1947. Without that write-up the public would conclude to a deficit in excess of \$3,000,000.00 in overall. This, of course, is posited on the unnecessary hypothesis that not only were the write-ups misplaced in December, but that they were illegitimate at base and completely unfounded, which is a predication that need not be pressed here. It would be difficult to assert that the amount involved here was not substantial.

Probably the most important single element affecting materiality was the *nature* of the increment. The investor is interested in (5) operating profits, and not in (6) unusual increment from non-recurring items,—at least in assessing the value of a stock to be purchased. It is most material to conceal or misrepresent this distinction. The investor, once he has invested, will be most happy to realize dividends from any source, be it a windfall from an inventory recount, or from a sharp upswing in prices affecting current inventory, or from the sudden retirement of an unnecessary inventory reserve, but these items are not of interest to him in his attempt to gauge the future earnings of the firm, since they are not profits from operations. “. . . Past earnings are significant only when they tend to reflect future returns.”⁸⁹ Thus Kaiser-Frazer was guilty of a double dereliction in putting inventory in the earnings totals, and in not telling what this amount was, granting for the sake of argument that it belonged here, which it did not. Both of these elements are material. Inventory in earnings is a misrepresentation. Concealment of the nature of this figure was non-disclosure. So, even if the inventory did belong in December, it should have been so denominated as inven-

⁸⁹ *United States v. Toronto Nav. Co.*, 338 U.S. 396, 403 (1949).

tory, since it affected so appreciably the investor's estimate of the profit trend.

By way of denouement, it is somewhat ironic to hear the Kaiser-Frazer attorneys, in a letter of July, 1947, advise Kaiser-Frazer's vice-president and director of the firm's duties in regard to the Prospectus:

Under the Securities Act of 1933, each director of the corporation is liable in the event the Prospectus contains any untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading. It is, therefore, essential that the Prospectus contain all facts, especially those of an unfavorable nature, which might affect the value of the stock offered or the possible earning power of the corporation.⁹⁰

There is one final reflection on the matter of disclosure. In the concerted reflection on what was concealed and misrepresented there is a tendency to overlook the ease with which the entire and true status of the company's earnings record could have been disclosed, either by giving the correct figures of monthly earnings from operations, or, less forthrightly, by footnoting the exact nature of the figures used. Even this latter method would be confusing, since there is no apparent reason, other than the desire to withhold the true state of affairs from the reader, for not giving a monthly breakdown. In an instance such as this where the chief emphasis is on the brief record of profits from operations, there is all the more reason for a month-by-month breakdown of operating earnings.

The Question of Otis' Knowledge

At many places throughout the Kaiser-Frazer briefs⁹¹ Otis is claimed to have had full knowledge of all the material facts concerning the earnings record. The Court of Appeals felt that "factually there is some support for Kaiser-Frazer's contention,"⁹² and that Otis, "... apparently took part in the preparation of the registration statement and the Prospectus."⁹³

A study of the record leaves clearly conflicting impressions. The Kaiser-Frazer brief cites an instance in the record where counsel for Otis is informed on January 20, 1948, of December earnings at \$300,000.00 to \$500,000.00.⁹⁴ This citation is offset by the declaration following immediately in the record where the same attorney was

⁹⁰ Letter of Walston S. Brown of Willkie, Owen, Farr, Gallagher & Walton, to E. E. Trefethen, Vice-President of Kaiser-Frazer Corporation, July 26, 1947, Defendant's Exhibit 151, R., V, 2962.

⁹¹ Appellee's Brief, 38, 42, 57; see note 53 *supra*.

⁹² 195 F. 2d 838, 843 (C.A. 2d, 1952).

⁹³ *Ibid*.

⁹⁴ R., III, 1527-29.

told on two or more occasions that "... the people in Detroit just didn't believe it; they thought there was some explanation of those figures and it wasn't anywhere near as bad as this report would indicate, and they wanted to set up a meeting to talk over the whole situation . . ."⁹⁵ And finally, this same attorney testified that on January 21, 1948, Edgar Kaiser "... spoke about Mr. Hamman being one of the younger men with Touche-Niven, that he had worked on the Kaiser-Frazer account there, that he had jumped at certain conclusions on the basis of some preliminary figures which, after analysis, were explainable . . ." by Edgar Kaiser.⁹⁶ Edgar Kaiser himself was asked if he told Otis' counsel on January 21, 1948, that the December figures did not indicate an adverse trend, and he testified: "I probably did, because I believed that at the time and I believe it now."⁹⁷

The net result of a perusal of the record is doubt, with the guarded conclusion being that Otis' counsel might well have had some suspicion of an unusual state of affairs⁹⁸ and could well have thereby been put on notice to investigate more fully. But it would seem that he did not truly appreciate the figures behind the record in the Prospectus.⁹⁹ The cautious expressions of the Court of Appeals probably best reflect the record on the point. Later considerations will seemingly have to be posited on the double hypothesis, that (1) Otis did have knowledge, and that (2) it did not.

Preparatory to a consideration of the duty to disclose and the extent to which the acts perpetrated violated that duty, this is the conclusion that has been reached thus far: The December earnings from operations, in contradistinction to inventory writeups, were not only concealed, but misrepresented, and these earnings and their misrepresentation were material.

The questions now are: Was this misrepresentation of a material fact a violation of a duty to disclose? What was that duty? To what extent was it violated?

The Disclosure Requirements in an Underwriting Venture

"... (2) violated the duty to disclose under the Common Law, the Securities Act of 1933, and the Contract itself. . . ."

From Part II:—Solution

⁹⁵ R., III, 1529.

⁹⁶ R., III, 1531.

⁹⁷ R., IV, 1928.

⁹⁸ See: R., III, 1527-29, 1631; IV, 1922; 1920; 1927-29; III, 1548-49; 1587.

⁹⁹ See: R., III, 1529, 1531-32; IV, 1932, 1941-42, 1928-29.

Taking the view from the hill-top, an underwriting venture in its totality,—from the earliest moment that the issue is contemplated to the last step after the public investor has received his stock,—involves two broad considerations in the matter of disclosure requirements. First and far more important, the underwriting venture is a general undertaking involving the public welfare and cloaked with public responsibility. Second, and less important, it is an arrangement involving the rights and duties *inter sese* of participating parties. These points of view are very important in an analysis of *Otis*. If the case is viewed, on the one hand, as simply an isolated, albeit noisy, battle between two litigants who should have known better, the array of rights and duties, violations and damages, claims and counterclaims, take on very definite and categorized aspects. If, on the other hand, every attention is directed toward the monumental truth that here is an important underwriting venture directed towards the general investing public and affecting its rights in a very intimate way, considerations that otherwise never would have entered the mind will be of great influence, even controlling.

The Venture as a Whole

This *Otis* case, then, clearly concerns itself principally with the essential nature of the total underwriting venture and the relation of that venture to the general public. The first duty in such a venture, incumbent on all the parties involved, is owed to the public investor. The prime considerations revolve around the question: Did the underwriting venture, and the contract that embodied its spirit, purpose and terms, conform in essence to the legal and moral standards of disclosure in protection of the investing public?

Once the venture as a whole is viewed as bearing a grave duty to the investing public, the next question to ask is: Who, among the persons party to such a venture, has the responsibility of seeing to it that this duty is performed, that the overall nature, purpose and terms of the enterprise conform to the disclosure requirements of law and morality? The duty is threefold and in order of incumbency and stringency:¹⁰⁰ (1) on the issuer;¹⁰¹ (2) on the underwriter;¹⁰² (3)

¹⁰⁰ The whole question of the ethical philosophy and the moral theology of the hierarchy of duties of the respective parties in an underwriting venture in relation

¹⁰¹ The issuer has first responsibility (see Section 6(a) of the Act) because his is the full control, his is the stock, to him goes the bulk of the purchase price, his is the full

¹⁰² The underwriter, as quasi agent for the issuer, has a great professional duty to the general public. His is the duty of reasonable investigation, prudent carefulness

on the government.¹⁰³ In making this breakdown of the overall duty, the point should not be missed that the primary question is not one of the violation of duty of any particular member of the underwriting venture, but rather of the total defection or deficiency of the essential nature, spirit, purpose and terms of the venture *qua* venture in its relation to the general investing public.¹⁰⁴ The consideration, then,

[Footnote 100 continued]

to the overall legality and morality of the total venture is a complex study in itself. Here is merely presented the conclusions from such a study, based on norms taken from the natural law, moral theology, the common law, the statutory legislation of the United States, especially the Securities Act and the rules and regulations of the SEC, and the custom and practice of the underwriting community.

[Footnote 101 continued]

knowledge of all the facts. In short, he is the one who is selling. (The public is the buyer, hence to him is owed the primary duty.) All this is borne out by the customs of the financial community and the hierarchy of liability in the Act. Thus, in Section 11(a) are listed in this order: any signer of the registration statement, directors or partners of the issuer, accountants, engineers or appraisers, and the underwriter. On the issuer devolves the duty of preparing the registration statement, of signing and filing it. Here should be noted the moral and legal responsibilities of the accountants in the employ of the issuer. Their duty is also great, subsidiary to the issuer of course, but certainly of a secondary liability and prior to that of the underwriter. Section 11(a). The act "goes as far in protection of purchasers of securities as plaintiff in *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor. The change which that court thought so 'revolutionary' as to be 'wrought by legislation' has been made. And the duty placed on experts such as accountants has not been measured by the expert's relation to his employer but by his service to investors." Douglas and Bates, *Federal Securities Act of 1933*, 43 *Yale L.J.* 197 (1933).

[Footnote 102 continued]

and general supervision. His relatively low emolument, the need for mass flotations, all decrease the demands that can be made on the underwriter. It should be noted, too, that the major underwriters are no longer protected by the lack of privity.

¹⁰³ The government as the duly authorized guardian of the commonwealth and the specific custodian of the public welfare bears the third position of liability. This duty is both general and specific. The government has, in general under any circumstances and in so far as possible, the duty to protect its citizens from harm. Specifically, under the present and current context of our United States government, there has been a specific delegation of this duty principally to the S. E. C. Section 8. This duty, however, should not be overemphasized. It is tertiary, to begin with, and is further limited in the specific instance of the SEC by restriction on the grant of power and the delegation of duty by the Federal government. Section 23 makes it very clear that the SEC has at best a negative duty. Consider also the announcement affixed to every prospectus as required by the SEC rules and regulations. See note 57 and body *supra*.

¹⁰⁴ The House Committee on the bill summed up the hierarchy of duty excellently: "... the duty of care to discover varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect." *A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act*, Department of Commerce, Hearings before Committee on Interstate and Foreign Commerce on H.R.

is directed in the first place to the essential nature of the venture, and the contract embodying it, and at the derelictions of the individual parties only in the second place and in so far as those derelictions infect the total venture and effect the net result of a violation of the rights of the public investor.

The Duties of the Parties Inter Sese

The second broad consideration, interwoven with the problem surrounding the venture as a whole, is the relation subsisting under law and the contract between Kaiser-Frazer the issuer and Otis the underwriter. The question there is: Have the actions of Kaiser-Frazer rendered the contract unenforceable in so far as it is referable to Otis? Considered on a strict contractual basis between Kaiser-Frazer and Otis alone, is the contract binding? Or did Kaiser-Frazer so breach the conditions of the contract as to excuse Otis from performance under it? This second broad question will be properly approached by the same study of the duty of disclosure.

What then are the standards of law and morals to which an underwriting venture must conform? What are the sources of these standards? The underwriting venture and the contract which embodies it,—as well as all the parties constituent of the venture,—are governed by duties and standards arising out of three great sources: (1) the Common Law; (2) the Securities Act of 1933; (3) the contract itself. Under these headings will be treated the nature, scope, and application of the disclosure requirements regulating an underwriting venture, and the extent of violation under each. The effect of the violation of these laws can then reasonably be discussed.

(1) *The Duty to Disclose at Common Law*¹⁰⁵

Both logically and chronologically the point of departure in a study of disclosure obligations is the common law. Statutory provisions have not superseded the common law, but merely built onto it, elaborated and refined it. Due to this background many of the concepts of the common law contribute appreciably to the interpretation of the modern statutes.¹⁰⁶ The common law action for deceit lay in

4314, 73d Cong., 1st Sess. 85. The stipulations granting contribution under Section 11(f) of the Act accentuate the joint duty of all to the general investing public.

¹⁰⁵ There is patently a double common-law consideration, tort and contract. The question of contract will be treated infra under the treatment of the enforceability of the contract.

¹⁰⁶ See Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 227 (1933). This differentiates common law deceit and the Act.

tort for damages. There are parallel, early, criminal statutes for sales under false pretenses.¹⁰⁷

The tort action of deceit requires six concurrent elements: (1) A false representation, (2) of a material¹⁰⁸ (3) fact, (4) made knowingly,—*scienter*,—to induce reliance, (5) with consequent reliance¹⁰⁹ and (6) damage.

Quite clearly since neither a public investor nor Otis actually purchased the securities on the basis of the representations in the Prospectus no action would lie in tort. The instant case is a suit in contract, by the seller, not the buyer. The question here rather is: What was the duty to disclose incumbent on Kaiser-Frazer at common-law tort? Of the six required elements only the first two,—a false and material representation,—contain the prescriptions for disclosure at common law. Since the question of materiality has been answered in substantially the same manner by both the common law and the SEC, the chief remaining points are the definitions of false representation, and *scienter*.

Rex v. Kysant (1932)

The prosecution of Lord Kysant under the English Larceny Act of 1861 is an important part of the legislative history of the Securities Act,¹¹⁰ illustrates excellently the common-law interpretation of a false representation, and offers highly suasive parity of facts with *Otis*.

Lord Kysant went to prison because the prospectus issued through his steamship line, incident to the sale of stock, was held violative of the Larceny Act which made it a misdemeanor for a director to make “. . . any written statement or account which he shall know to be false in any material particular in order to effect a sale of stock.” All of the statements made in the prospectus were perfectly true, but when considered in total context and in the light of what was not said, they made the prospectus false. The true average net income for the ten years before 1928 was given. The dividends declared and paid over the previous seventeen years were listed. It was openly admitted that the company had suffered, with the entire industry, during the

¹⁰⁷ The earliest is 30 Statute of Geo. II, c. 24 (1757). See 2 Wharton, Criminal Law (12th Ed., 1932) § 1395 et seq., Statutory Cheats by False Pretenses.

¹⁰⁸ Discussion of materiality *supra* page 160 et seq.

¹⁰⁹ This point will be discussed *infra* at page 74 “. . . (6) and notwithstanding alleged estoppel due to Otis' knowledge.”

¹¹⁰ The rule in this case became part of the Securities Act. See Frankfurter, The Federal Securities Act: II, *Fortune*, August, 1933, p. 108. *Rex v. Kysant*, [1932] 1 K.B. 442.

depression years. But the prospectus neglected to state (1) That the bulk of the profits had come from increased business in postwar 1918, (2) That these profits were all centered in the three war-end years, and (3) That the following seven years were very lean indeed. As with *Otis*, two very material points were concealed: (1) The non-recurring nature of the profits, and (2) The downward trend in earnings. The court held that in spite of the literal truth of each statement, the prospectus as a whole gave a false impression.

The Supreme Court of the United States has given evidence of concurrence with the rule in *Kylsant*. In the *Equitable Life Insurance* case an investment banking house, in the sale of a municipal bond issue to the plaintiff, omitted to reveal the declining financial state of the guarantor on the bonds, a lumber company. The Supreme Court paraphrased the Restatement with approval: "... a statement of a half truth is as much a misrepresentation as if the facts stated were untrue."¹¹¹ The common law, however, fails to hold a person liable for complete nondisclosure unless the party has a particular duty to use reasonable care to disclose "... because of a fiduciary or other similar relation of trust and confidence between them ..." ¹¹² or "... by concealment or other action intentionally prevents the other from acquiring material information."¹¹³

The question of *scienter* is important in so far as it indicates the manner in which the duty can be violated. If there is a misrepresentation of a material fact, must it be made with deliberate intent to deceive, or simply with knowledge of the falsity, or is innocent error sufficient where there is a duty to avoid such errors and the misrepresentation is in fact material and misleading? Early constructions of *scienter* at common law made recovery for deceit almost impossible and it was necessary in effect to prove thievery. Gradually, however, the courts broadened the definition of the concept to the extent of holding the defendant for culpable negligence. Thus the Federal Court of Appeals in *Stein v. Treger* has stated that "Where a party innocently misrepresents a material fact by mistake . . . such misrepresentation will support an action for fraud."¹¹⁴

¹¹¹ *Equitable Life Insurance Co. of Iowa v. Halsey, Stuart & Co.*, 312 U.S. 410, 424-26 (1941), 36 Ill. L. Rev. 117 (1941). Thus also: "A statement in a business transaction which, while stating the truth so far as it goes, the maker knows or believes to be materially misleading because of his failure to state qualifying matter is a fraudulent misrepresentation." Restatement of Torts, § 529. See also: *Newman v. Corn Exchange National Bank and Trust Co.*, 356 Pa. 442, 51 A. 2d 759 (1947).

¹¹² Rest., Torts, § 551 (1938).

¹¹³ Rest., Torts, § 550 (1938).

¹¹⁴ 182 F. 2d 696, 699 (App. D.C., 1950).

Evaluating the state of intent in Kaiser-Frazer there is little doubt that there was at least full knowledge of the misrepresented facts. Otis felt it could prove intent to deceive, but allowed that that was not necessary. It would seem that a favorable construction on the words of Edgar Kaiser would also indicate that although there was knowledge of the misrepresentation it was in good faith and with a conviction that what was de facto misleading, material and false, was the truth. Put another way, Kaiser-Frazer was guilty objectively, but not subjectively. Thus Kaiser-Frazer would have *scienter* even without resort to the liberal rule of the *Stein* case, since there was no mistake but full knowledge, albeit the misrepresentation may have been innocent.

In general it can be said, irrespective of what the event would be in regard to proof of the other elements requisite to common-law tort,¹¹⁵ that Kaiser-Frazer was clearly derelict under the common-law norms of disclosure. At most the earnings record in the Summary was a half-truth, and Kaiser-Frazer presented it with full knowledge that was at best naïvely innocent and a culpable error of judgment.

(2) *Statutory Legislation*

In the present-day, well-legislated context of the United States the prime norm for disclosure in an underwriting venture is to be found in the statutory provisions of three acts. The provisions are superimposed on the common law, and although not superseding it they have, as a practical matter, supplanted it both as to feasibility of remedy and specificity of requirements. All three of these statutes have application to the *Otis* case. Although both the Mail Fraud Statute¹¹⁶ and the Securities Exchange Act of 1934¹¹⁷ have similar provisions, the various sections of the Securities Act of 1933 are more intimately applicable to Otis and warrant direct treatment.

Preliminary Considerations

The study of the securities legislation as applied to the *Otis* case must be kept within three broad frames of reference: (1) The double point-of-view:—the total venture in relation to the public investor, and Kaiser-Frazer to Otis. (2) The double question:—Did Kaiser-Frazer's misrepresentation violate each particular provision? Could

¹¹⁵ The prospects for the plaintiff in the common-law action of deceit are not promising and the obstacles are almost insuperable. See, Shulman, note 106 *supra*, 230 to 235.

¹¹⁶ 18 U. S. C. § 1341. (1948).

¹¹⁷ 15 U. S. C. § 78. (1950).

Otis recover? (3) The double hypothesis concerning Otis' knowledge of the misrepresentation:—that Otis did and did not have full knowledge.

The Securities Act of 1933

From the words of Franklin Roosevelt in his message recommending the Act to Congress “. . . no essentially important element attending the issue shall be concealed from the buying public . . .”¹¹⁸ to the summary of the legislative purpose—“The basic policy underlying the act is that of informing the investor of the facts concerning securities and providing protection against fraud and misrepresentation”¹¹⁹—there has been one clear aim,—full disclosure, and protection of the public investor against deception.

Substantially the same requirements are set down in *four different sections* of the Act, but they are adapted to applications necessary under varying circumstances. Considered broadly, the Act forbids (1) any misrepresentation or non-disclosure of a material fact (2) in the sale of securities (3) in interstate commerce or the mails.

Still viewing the Act broadly, these requirements are supported by sanctions of three kinds:—(1) The stop-order issued by the Commission preventing the sale of securities. (2) The civil liabilities of all parties responsible for the flotation. (3) Criminal liability.

The Relevant Provisions of the Act

Toward full disclosure the Act requires that the investor be furnished with the facts essential to an intelligent judgment of the value of the security being offered for sale. This information is contained in the Registration Statement filed with the Commission and the Prospectus supplied to the investor. Supporting this requirement is the stop-order sanction of Section 8(d):

(d) If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact . . . the Commission may . . . issue a stop order suspending the effectiveness of the registration statement.

In the early Kaiser-Frazer attempts to secure an effective order for the Registration Statement the SEC required rectification of certain deficiencies in the statement. The Registration Statement, however, that eventually became effective and the Prospectus actually handed

¹¹⁸Message to Congress of Franklin Roosevelt, March 29, 1933, Hearings, see note 104 *supra*, 1.

¹¹⁹McCormick, *Understanding the Securities Act*, 24.

to Otis as final were cleared by the Commission. The only relevance of this to the Otis litigation,—beyond indicating the broad purpose of the Act,—is the fact that the Commission did not avail itself of the stop-order after its review of the Registration Statement and Prospectus. It is submitted, however, that a study of the record leads to the conclusion that this action is almost completely negated by (1) the frequent attempts, overruled, of Otis to prove that the SEC had never received the full facts prior to the effective order and been deceived in the same manner as Otis itself,¹²⁰ (2) by the limitations on the SEC's grant of power,¹²¹ (3) by its clear purpose not to act in approval of the accuracy and adequacy of the statement,¹²² and (4) by the handicaps of time and the absence of an audit or complete accounting picture of Kaiser-Frazer.

It is pertinent to note that the stop-order issues regardless of intent or knowledge in the issuer, but solely on the basis of a misrepresentation of a material fact and is issued in protection of the public investor.¹²³

Civil Liability

Once the Registration Statement is effective and the Prospectus is issued, the second set of sanctions comes into operation. Section 11 treats at length of the Registration Statement, and imposes civil liability for misrepresentation or non-disclosure on (1) the issuer, directors, principal officers, (2) accountants, and (3) underwriters.

Sec. 11. (a) In case any part of the registration statement, when such part became effective, contained any untrue statement of a material fact, or omitted to state a material fact . . . , any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue—

- (1) every person who signed the registration statement;
- (2) every person who was a director . . . or partner in, the issuer . . .
- (4) every accountant, engineer, or appraiser . . .
- (5) every underwriter . . .

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable . . . who shall sustain the burden of proof—

. . .

¹²⁰ See note 70 and body.

¹²¹ See note 69 and body.

¹²² Ibid.

¹²³ A material concealment is a violation of this section without regard to wilfulness or intent. *Unity Gold Corp.*, 1 S. E. C. 25, 29, 18 F. T. C. 649 (1934); *Emporia Gold Mines, Inc.*, 2 S. E. C. 209, 221 (1937); *Herman Hanson Oil Syndicate*, 2 S. E. C. 743, 746 (1937); *Kiwago Gold Mines, Ltd.*, Sec. Act Rel. 3278 (1948) 8.

(3) that . . . he had, after reasonable investigation, reasonable ground to believe, and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact . . .

In stating the liability of the various parties in this particular way the Act does two things. It emphasizes the group duty of the venture to the general investing public, and highlights the hierarchy of responsibility within that group.¹²⁴ "This proposal adds to the ancient rule of caveat emptor the further doctrine 'let the seller also beware.'"¹²⁵

Section 12(2) complements in the matter of the Prospectus the provisions of Section 11 relating to the Registration Statement and imposes civil liability on the seller for damages or rescission. Any person who

. . . sells a security . . . by means of a Prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . shall be liable to the person purchasing such security . . .

These two sections of the Act bear on the case indirectly, but nonetheless very effectively. They (1) set the stage for consideration of the contract, which incorporates the Act into its terms, (2) tell forcibly what Kaiser-Frazer and the accountants would have faced in the event of a consummated sale, (3) indicate what recovery Otis could expect at law or equity, and (4) show what remedies would lie in third party purchasers against Otis.

There can be little doubt that the Registration Statement, *when it became effective*, contained a prospective violation of Section 11(a). This establishes a cause of action against Kaiser-Frazer in any person acquiring the securities,—namely Otis and the public investors, provided there was no knowledge of the misrepresentation. This liability on the issuer is absolute, with the one exception, the defense of knowledge in the buyer. With knowledge, therefore, there is no recovery. The accountants would face the same liability to Otis, but with the added benefit of the provisions of Section 11(b).

¹²⁴ That the Act regards this as a group liability of all five categories vis-à-vis the general public can further be understood by the provisions of Section 11 (f) specifying contribution in the event of violation:

(f) All . . . persons . . . shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution . . . from any person, who, if sued separately, would have been liable. . . .

¹²⁵ Roosevelt, Message to Congress, see note 118 *supra*.

Thus the liability of Kaiser-Frazer is independent of the question of intent to deceive or knowledge of the misrepresentation. This defense is open to others than the issuer, but not to Kaiser-Frazer. It matters not whether the misrepresentation was made in good faith, was an innocent clerical error, a mistake in judgment or a fully deliberate intent to deceive. All that is requisite is that it be a misrepresentation or non-disclosure of a material fact. That the misrepresentation also be misleading is not necessary. Thus the common law requisites have been substantially altered.

Kaiser-Frazer would face a similar liability in regard to the Prospectus, with the added exception under Section 12(2) permitting the defense of absence of knowledge of misrepresentation.

Consider next the result under Section 11 of a *resale by Otis to the public investor*. In order to escape liability for damages or return of the purchase price, Otis would have to show an absence of knowledge or misrepresentation or that it "... had, after reasonable investigation, reasonable ground to believe ... the statements therein were true ...". And the investigation devolving on Otis under Section 11(c) is that "... of a person occupying a fiduciary relationship." It is only in regard to the issuer that the liability is absolute. Under Section 12(2) Otis would be subjected to the same liability by use of the Prospectus, and would have to "... sustain the burden of proof that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."

If Otis actually had *full* knowledge of the misrepresentation, what would result? The public investor buying without knowledge of the misrepresentation would have a cause of action for rescission or return of the purchase price and Otis would be liable under both Sections 11 and 12(2).

Assume likewise that Otis was innocent of all knowledge at the effective date of the Registration Statement and the issuance of the Prospectus, but for the first time had reasonable belief of misrepresentation just prior to the closing.¹²⁶ Here Otis was in substantially the same position as if it had the full knowledge from the beginning, since it would be going ahead towards sale with a cogent conviction of misrepresentation. This, *de facto*, is the position that Otis itself alleges the record shows it had in the actual event. Since, as the event itself proved, there was ample time in which to terminate the contract, return the money already collected from the public investors,

¹²⁶ See note 115, *supra*.

and restore all to the *status quo ante*, Otis, under this hypothesis, would be consummating the sale with culpable knowledge if it completed the last details of the sale with the public by tender of the stock. This would again result in liability in Otis to the innocent public purchaser.

Consider the other hypothesis that Otis had not full knowledge but simply a mere suspicion of misrepresentation. What would be the results of a sale to the public? The crux would be the extent of knowledge and investigation. Since the norm is that of a fiduciary, Otis would be expected to follow up any suspicions and resolve any doubts before proceeding.

Had Otis no knowledge from beginning to end there would have been no liability at the hands of the public purchaser.

Criminal Liability

The final¹²⁷ sanction under the Act comes in the anti-fraud provisions of Section 17(a) which impose a criminal liability on the would-be-seller for any willful misrepresentation or non-disclosure of a material fact:

Sec. 17. (a) It shall be unlawful for any person in the sale of any securities . . .

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact . . .

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

There are provisions homologous¹²⁸ to this section in the Mail Fraud Statute¹²⁹ and the Securities Exchange Act of 1934.¹³⁰

¹²⁷ Section 14 warrants considerable discussion, but is more properly treated in connection with the unenforceability of the contract. First see note 34 *supra*, for the wording of the section, then *infra* in body.

¹²⁸ For treatment of the interrelations of these various anti-fraud provisions, see Loss, *Securities Regulations*, 811 *et seq.*

¹²⁹ "Whoever having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations or promises. . . ." 18 U. S. C. § 1341 (1948).

¹³⁰ See Section 10 of the Securities Exchange Act of 1934. Under this section the Commission has promulgated Rule X-10B-5:

"Employment of Manipulative and Deceptive Devices—It shall be unlawful for any person . . .

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact . . .

(3) to engage in any act, practice, or course of business which operates or would

These sections carry great impact on the *Otis* case. Under paragraph (3) of Section 17(a) Kaiser-Frazer might be said to be already subject to criminal liability since it has long embarked on a "... transaction, practice or course of business which . . . would operate as a . . . deceit upon the purchaser." Here there is no need for the consummated sale. The filing of the Registration Statement and the use by Otis of the Prospectus have set the "course of business" into operation.

Should Otis have effected a sale to the public the same criminal liability of these sections would attach.

The reasoning applied under the civil liability provisions in connection with Otis' termination is, *mutatis mutandis*, relevant here. Otis would have been acting in violation of a criminal statute were it to have carried through the contract and sold to the public.

In regard to the intent of the seller under Section 17(a) reference is had to Section 24 which is the criminal provision. In addition to making it unlawful "willfully" to violate any section of the Act, Section 24 specifies the crime of "wilfully" making any untrue statement in a registration statement. It would seem, therefore, that at least knowledge of the falsity is required, if nothing further. This would render the requirements under Section 17(a) in the matter of knowledge in the seller practically identical to those under Section 12(2) and Section 11, except of course, that the liability of the issuer under Section 11 is absolute.

The Securities Act in Otis

Preparatory to an analysis of the contract there are several reflective conclusions necessary for the proper perspective of the Securities acts in the *Otis* case. It must be borne in mind that: (1) Otis, the buyer, terminated before closing and left the burden of prosecution with Kaiser-Frazer, the seller. (2) There was no actual sale. (3) Kaiser-Frazer was suing in contract for breach. (4) The only actions under the Act are by buyer against seller after sale, except the stop-order which is not technically an action, and the criminal provisions, which are unenforceable by Otis. (5) Otis had no cause of action under the Act. (6) The Act offers no remedy for a failure to buy, or

operate as a fraud or deceit upon any person in connection with the purchase or sale of any security."

The Securities Exchange Act carries the added section (29b) which renders void any contract specifying performance which would involve violation of any provisions of the act, or rules or regulations supplementing it. There is a second anti-fraud provision in the Securities Exchange Act:—Section 15 (c) (1) and Rule X-15C1-2 under it.

for seller against buyer. (7) Any violations of Sections 11 and 12(2) by Kaiser-Frazer were in a sense only *in vacuo* or in anticipation of a sale to Otis. (8) The provisions actually violated by Kaiser-Frazer were the anti-fraud Section 17(a) and parallel sections.

This is why every hypothesis in the discussion of the Act was premised on (1) a consummated sale (2) with the action by Otis against Kaiser-Frazer or (3) by the public investor against Otis, since there is no provision in the Act which would give Kaiser-Frazer an action against Otis, with or without a sale. The action had to be in contract. Thus the only approach to the Securities acts is in reference to the contract.

The next question to ask, once these verities are in mind, is: Are the misrepresentations a defense for Otis? Can Otis, completely irrespective of the contract, block recovery by total reliance on the Securities Act? The Act is posited on the assumption of a consummated sale and offers no defense to a suit for failure to sell, except for the possible applicability of Section 14. The violations of Kaiser-Frazer might be such, when held up to Section 14, as to constitute a valid defense. But this would be essentially a contractual ground, and is the very subject to be treated in connection with the enforceability of the contract.

(3) *The Provisions of the Contract*

The contract did two very important things. (1) It doubly warranted that "... when the Registration Statement becomes effective, the Registration Statement and the Prospectus will fully comply with the provisions of the Act . . . and neither . . . will contain any untrue statement of a material fact nor omit to state any material fact . . ."

(2) It made compliance with the warranty a condition to Otis' performance.

This warranty and this condition change the whole thrust of the case. Up to this point the question was whether Otis could resort to the Act as a defense, since there had been no actual sale. Now, two marked changes have been effected: (1) The contract warranted complete compliance with all the provisions of the Act. This converted the violation of the criminal provision of Section 17(a) and the non-compliance with Sections 11 and 12(2) into breaches of the warranty, whereas under the Act alone they offered Otis little help. The warranty merely specified non-compliance with any provision of the Act, and did not require a consummated sale or a full cause of action. (2) Even were no violations of the Act adduced, still the sim-

ple warranty of truth and disclosure was sufficiently breached by Kaiser-Frazer as to render unnecessary any resort to the Act.

The contract allows no exception for innocent mistake or absence of knowledge. If there is a misrepresentation or non-disclosure of a material fact there is a breach of the warranty.

Since compliance with these two warranties is a condition to performance, the moment the Registration Statement was declared effective by the SEC on February 3, 1948, Kaiser-Frazer was guilty of a breach of both warranties through (1) specific violations of Sections 11, 12(2) and 17(a) of the Act, and (2) misrepresentation and non-disclosure in the Registration Statement. This released Otis from the obligation to purchase and exculpated it from any liability in terminating before the closing.

But all of this is true only if Otis can prove that it had no knowledge of the misrepresentation. Which brings the argument back to the double hypothesis: (1) If Otis was innocent of all knowledge, the case could rest at this point, since Otis would have a valid defense in the breach of warranty, and Kaiser-Frazer could not counter with estoppel or waiver due to knowledge.¹³¹ (2) But if Otis cannot prove innocence of knowledge, the argument must go forward on the assumption, *ex arguendo*, wrong as it may well be in fact, that Otis did have full knowledge. If Otis can show a valid defense on this assumption,¹³² it has then succeeded in grasping both horns of the dilemma and founded a cogent argument on both sides of the double hypothesis. Henceforward the assumption will be that Otis had full knowledge.

The Misrepresentation as Essential to the Venture

“ . . . (3) and, as integral to the whole underwriting agreement . . . ”

From Part II:—Solution

¹³¹ “A buyer is estopped from later asserting unstated defenses of which he had full knowledge at time of termination only where the seller, if notified, could have cured the defects if he had been warned.” Appellant’s Reply Brief, 16, see note 36 supra. *Land Oberoesterreich v. Gude*, 109 F. 2d 635, 639 (C.A. 2d, 1940); *Cawley v. Weiner*, 236 N.Y. 357, 140 N.E. 724 (1923); *Peterburg Fire Brick & Tile Co. v. American Clay Machinery Co.*, 89 Ohio St. 365, 106 N.E. 33 (1914); *List & Son Co. v. Chase*, 80 Ohio St. 42, 88 N.E. 120 (1909); *Frick Co. v. Baetzel*, 71 Ohio App. 301, 47 N.E. 2d 1019 (1942).

¹³² The question of Otis’ knowledge would be treated in one of two ways, should later argumentation be found inadequate: (1) The case would be remanded for fuller investigation into the question of fact, or, more reasonably, (2) the evidence already adduced in support of the contention that Otis had knowledge would be declared insufficient to bar the defense of the breach of the warranty.

There has been ample proof of a material and misleading misrepresentation in the Prospectus. The question now is: Does this misrepresented state of the earnings go to the heart of the total transaction?¹³³ Or is it merely an immaterial element that can be changed without substantially affecting the contract? Does the intent of the parties and the overall tenor of the venture permit substitution of a different and downward trend of profits? Can the evil be expunged as a collateral and accidental feature, or does it constitute the essence? In other words: Was this income record so fundamental to the enterprise that its excision would basically alter the contract and pervert the original intent—in effect substitute an altogether different agreement?

The intent of the parties was clear from the outset. First, Otis advised Kaiser-Frazer that a flotation would be impossible until it presented a better earnings record.¹³⁴ Later, Kaiser-Frazer approached Otis and stated that the profits were up and the summary would warrant the offering.¹³⁵ From beginning to end the question of income was controlling in determining whether or not an issue *could* and *should* be floated. (The state of the market determined *when* it would be undertaken.) There is no doubt that Kaiser-Frazer and Otis had no intention at all of proceeding if the earnings from operations showed a downward instead of an upward trend, or admitted such substantial padding from inventory write-ups. If the \$4,000,000.00 had been allocated to the prior months and not been shown in December, Otis would never have agreed to the issue, nor would Kaiser-Frazer

¹³³ To avoid a captious compounding of questions the assumption throughout will be that the written contract adequately expressed the full intent of the parties and that the purposes, spirit and intent of the toal underwriting venture are coterminous with the contract. The only cavil that might disturb this reasoning is the question of whether *the* rather than *a* Prospectus was incorporated into the contract. Here the intent was clear. The Registration Statement and Prospectus had been prepared, were fully ready for filing and were sent off to the SEC within a few hours, if not minutes, after the signing of the contract. There is no doubt but that *this* Prospectus was the one incorporated into the contract, and not *a* Prospectus. Should this still not be clear, in and of itself, and perfectly within the four corners, as Williston says: "The intent may be inadequately expressed, but the language of the writing . . . nevertheless indicates the intent by the general tenor and purpose of the contract if taken in connection with surrounding circumstances." Williston, Contracts § 610 et seq. (Rev. Ed. 1938). The reasons adduced in the body to show that the misrepresentation was integral to the contract and the venture will at the same time prove that the written contract and the general venture can be spoken of interchangeably.

¹³⁴ R., III, 1386-87; IV, 2012-13.

¹³⁵ R., III, 1388-89.

have proposed it. Otis and Kaiser-Frazer did not first agree to buy and sell under any conditions, and then later look at the income. They finally agreed to the issue because and on the necessary stipulation that the profit trend published in the Prospectus was such as there represented. Both parties realized that no public issue could be attempted without the favorable income graph in the Prospectus.¹³⁶

All this the contract bore out. Truth was a condition to performance, and especially truth in the matter of the financial state of the firm. Kaiser-Frazer gave the specific warranty that ". . . there has been no substantial adverse change in the condition, financial or otherwise, of the Company . . ."¹³⁷

In short, the figures as misrepresented were a necessary element of the undertaking. They were intrinsic to the agreement. Change them and the contract changed. Excision of the misrepresented fact would change the essence of the agreement.

The Rights of the Investing Public

" . . . (4) and essentially looking to the detriment of the public investor . . . "

From *Part II:—Solution*

At this point there must be a complete shift in emphasis. In the preceding considerations the outlook was that of Otis as a litigant in an action by Kaiser-Frazer. This point of view will perdure, but in a definitely second place. Now it will become more clear why such meticulous care was expended in indicating the more important relationship of the entire Kaiser-Frazer-Otis underwriting venture to the general investing public. Henceforward the viewpoint is that of the third party investor. The master key to this *Otis* case lies in the protection of the rights of the public. Whether Kaiser-Frazer or Otis is successful in the instant litigation is secondary. It should be understood that Otis does not win, nor Kaiser-Frazer lose. What in truth happens is that the public investor wins, and both Kaiser-Frazer and Otis are simply told that they, and their accountants and brokers, are to stop the flotation, that their contract is illegal, that as illegal it is unenforceable,—unenforceable by any party, Kaiser-Frazer, or even

¹³⁶ "The Prospectus, which has been found to have been misleading, formed an integral part of the contract and the public sale of the stock by the underwriter was to be made and could only have been made in reliance on that prospectus." *Kaiser-Frazer v. Otis & Co.*, 195 F. 2d 838, 844 (C.A. 2d, 1952).

¹³⁷ Section 1(e) of the Contract, R., I, 15. See also Section 1(f) of the Contract, *supra* note 10.

Otis, should Otis seek enforcement. Thus, in protecting the third party investor the adjudication merely lets the chips fall where they may, and it happens *per accidens* that Kaiser-Frazer does not retrieve its desired \$3,000,000.00, nor does Otis have to pay it. In this sense, Otis wins and Kaiser-Frazer loses, but that is inaccurate terminology, for the adjudication is merely leaving the parties in status quo in protecting the general investing public. As soon as the *Otis* case moves into this area of consideration the equities of the two parties, Kaiser-Frazer and Otis, are no longer in forefront. Now the emphasis is on the third party public.

At this point the question is: Does the misrepresentation in the Prospectus stop with Otis, or carry over inevitably to the public? Was this an isolated operation between two parties, or does it look exclusively to a public sale? Was the public sale also intrinsic to the contract? An essential stipulation?

Three general areas of inquiry indicate that the Kaiser-Frazer-Otis transaction was not a private bargain but envisaged a public offering: (1) the traditional mechanics of the flotation, (2) the nature of the agreement, (3) the terms of the contract.

Kaiser-Frazer and Otis had agreed to a *form and procedure of underwriting* that was not substantially different¹³⁸ from the traditional "firm commitment" type in common use in such flotations. This method involves several steps all leading to a sale to the general public immediately upon the signing of the contract. Kaiser-Frazer was to, and did, prepare, sign and file the Registration Statement with the SEC. The actual issue began on the morning following the effective order. Kaiser-Frazer sent out the Prospectus to the selling group for public use. The sale itself was well under way and the stock half sold when Otis terminated. From beginning to end everything in the venture followed the established customs and practices leading only to one culmination: a sale to the public investor.¹³⁹

The *nature of the transaction* and the *intent of the parties* point to a public sale and nothing else. From the outset, second only to the

¹³⁸ The deal did have its own peculiar variation. The original firm commitment for 1,500,000 shares was changed to 900,000 "firm" and the remaining on an option basis at a higher price. Rider to Prospectus, page 1.

¹³⁹ The Circuit Court understood this when it stated: "We cannot blind ourselves to the fact that the sale of this stock by Kaiser-Frazer, though, in so far as the particular contract was concerned, was a sale only to the underwriters, was but the initial step in the public offering of the securities which would necessarily follow." *Kaiser-Frazer v. Otis & Co.*, 195 F. 2d 838, 844 (C.A. 2d, 1952).

concern over Kaiser-Frazer's earning record (which in itself meant nothing if it were not to be used in encouraging public purchase), was the worry over the market price. The issue was held upon prior occasions due to a poor market and when actually begun the issue required an immediate distribution in order to capitalize on the current market price. Otis had neither the intent nor the capital to retain the shares, but had floated a one-day loan with which to effect the transaction at the closing.

The *terms of the written contract* establish further the intent of all in the enterprise. The price, published prominently on the first page of the Prospectus, was based on the market, and listed the separate figures for the selling group and the public. Kaiser-Frazer itself agreed to stabilize the market in preparation for the public sale. The contract specified that Kaiser-Frazer was to supply as many copies of the Prospectus to securities dealers ". . . as may be required for use in connection with the public offering of the Shares."¹⁴⁰ Finally, the warranties, as conditions, became binding, "When the Registration Statement becomes effective . . ." indicating complete preparation for immediate public vending. In incorporating the provisions of the Securities Act into the contract Kaiser-Frazer further warranted that the venture would pursue the basic purposes of the Act in protection of the public investor.

The intent of the parties included a sale to the public as intrinsic to the contract, an essential element of the agreement.

If a venture leads inevitably to a public sale based on a material misrepresentation, integral to the whole enterprise, that sale will likewise inevitably lead to a violation of the rights of the investor and to his material detriment. This is probably one of the most important concepts in the *Otis* case, because if an inseverable nexus is not established with the innocent public, the later reasoning will fail.

The Enforceability of the Contract

"... (5) rendered the Contract illegal, and hence unenforceable . . ."

From *Part II:—Solution*

The denouement in the analysis of *Otis* comes in the application of the general rule against enforcement of contracts which essentially look to the performance of illegal acts. Williston calls them "Corrupt

¹⁴⁰ Section 2(d) and (f) of the Contract, R., I, 17.

or Immoral Bargains," and among the various types and subdivisions he lists those in violation of the rights of innocent third parties. He states the rule thus:

In general a bargain which contemplates a wrong to a third person, or to undefined members of the public, whether trespass, breach of trust, or fraud, is illegal.¹⁴¹

To this, Williston adds a further specification more pertinent to the instant investigation:

A bargain to refrain from disclosing to a third person to whom a duty of disclosure exists, information of value or interest to him, is illegal.¹⁴²

These principles, joined to the considered reflections already presented, indicate the five elements of the particular rule specifically applicable to the facts in *Otis*: A bargain is illegal which contains (1) a misrepresentation or non-disclosure, (2) integral to the agreement, (3) inevitably looking to, (4) harm or detriment, (5) to innocent third parties.

The basic reason why such bargains are unenforceable is the evil inevitable in their performance. To avoid this evil the courts cannot permit enforcement. Could the evil, here the harm to the innocent, be obviated in any other way, the courts would not be forced to declare the contract either invalid or illicit. The law must protect itself. An agreement to violate the law is a violation of the law.

This introduces a dialectical point of some nicety. If the two elements of *integrality* and *inseverable relation* of the falsity to the public are not posited as intrinsic to the essence of the contract, but merely as necessary conditions *sine quibus non* (which is the least they can be) and outside the four corners of the contract but necessary to it, the contract could conceivably be said to be "valid on its face." If, however, as has been here affirmed throughout, these elements are substantial and integral parts within the four corners, fully incorporated into it, the contract is not "valid on its face," but is *in se* corrupt and immoral, as having falsity inherently constituting its essence, and is, therefore, not only illicit, but invalid. In the former supposition the contract would be only illicit, but not invalid. The one is only *per accidens* corrupt, the other *in se*. The practical effects in *Otis* are the same, since both types of contract are illegal, and hence unenforceable, and the same proofs must be adduced in

¹⁴¹ Williston, Contracts. § 1738, page 4912 (Rev. Ed., 1938).

¹⁴² Ibid., at 4914, with cases cited.

each instance, since, either as necessary conditions or intrinsic elements, both *integrality* and *inevitable perduration* must necessarily be present.

Materne v. Horwitz

An early New York case states the rule in *Otis* with almost primitive simplicity. Materne agreed (1) to sell Horwitz low-grade sardines and (2) to supply a batch of "high-grade" labels. At the time of the agreement Horwitz knew what type sardines he was going to get, and Materne knew he understood this. Materne also knew that Horwitz entered the contract with the purpose of selling the sardines exactly as received. "It is also evident that the labels were used to deceive the consumers and not the contractors, and to obtain higher prices for the sardines." At this point Horwitz terminated. Materne sued for breach. The court held:

It is, therefore, apparent that it was part of the contract that an unlawful object was intended, of which both parties were cognizant, and that it was designed by them, under the contract, to commit a fraud and thus promote an illegal purpose by deceiving other parties. In such a case the courts will not aid either party in carrying out a fraudulent purpose.

To carry out this contract would be contrary to public policy, and in such a case, as we have seen, the court will not aid either party.¹⁴³

The parity with *Otis* is patent. The principle of the *Materne* case lies at the base of the reasoning of the Circuit Court¹⁴⁴ when it says: ". . . we are satisfied that the contract was so closely related to the

¹⁴³ *Materne v. Horwitz*, 101 N.Y. 469, 471, 5 N.E. 331, 332 (1886).

¹⁴⁴ It seems otiose to enter a discussion concerning the applicability of Section 14 as a statutory provision voiding contracts contrary to the policy of the Act. The Court of Appeals sought, in a footnote (see *supra* note 34 and body), some support from the section, but Kaiser-Frazer alleged that it did not apply, according to legislative intent, and adduced the Securities Exchange Act in proof. The '34 Act, asserted Kaiser-Frazer, had the exactly homologous provision of Section 14 in Section 29(a), but also had the additional Section 29(b). Whereas Section 14 and Section 29(a) rendered void only those contracts which had a "condition, stipulation or provision" which *waived* compliance with the Act, Section 29(b) rendered void any contract the performance of which would involve a violation of any provisions of the Act or of any rule or regulation thereunder. See note 130 *supra*. The argument was that there was no such condition, stipulation or provision in the instant contract, and that if Congress had wanted a voiding clause for simple non-compliance under the '33 Act it would have added a homologue to Section 29(b), since both the '34 Act and notable amendment of the '33 Act were passed at the same time. Discussion of this is unnecessary for two reasons: (1) the general contract principle against corrupt and immoral contracts is controlling, and (2) the misrepresentation violated the '34 Act as well and the voiding clause there would apply.

performance of acts forbidden by law as to be itself illegal.”¹⁴⁵ In short, both contracts, in *Materne* and *Otis*, have an essential relation to the performance of illegal acts. These acts the respective courts cannot countenance and the only means available for preventing them is a declaration of unenforceability. In both cases, moreover, the envisaged evil is internal to the agreement and infallibly related to the harm of the innocent public. The New York court stresses these points when it says that “an unlawful object” was “part of the contract,” and the deception of the public was contemplated “under the contract.” These fill out the five requisites of the rule against enforcement. Since all are intrinsic to the essence, not merely conditions *sine quibus non*, both contracts are not only illicit but invalid *ab initio* and hence unenforceable.

The Frost Case

Kaiser-Frazer, of course, would not directly dispute this general principle of contract law. It rather did two things; it ignored it as a broad contractual principle over and above the Securities Act, and it endeavored to shift the entire force of the rule into exclusively Securities Act channels, where it was clearly not meant to be, either by the Court of Appeals or *Otis*. Once the argument was diverted into a question of unenforceability under the Securities Act, Kaiser-Frazer cited *A. G. Frost & Co. v. Coeur D’Alene Mines Corp.*¹⁴⁶ with which the *Otis* “. . . decision is in direct conflict.”¹⁴⁷ The *Frost* opinion is admirably suited to highlight the distinctions thus far delineated.

The contract involved in the *Frost* case was between underwriter and issuer for shares of stock. Midway during performance the contract was terminated and liability denied on the ground that the contract “was entered into in violation of law, and particularly . . . the Securities Act . . .”¹⁴⁸ The contract was fully legal and valid on its face. In the process of performance, however, the issuer failed to

¹⁴⁵ 195 F. 2d 838, 844 (C.A. 2d, 1952). Thus the Court does not specify whether the relation that the contract has “to the performance of acts forbidden by law” is one of a condition *sine qua non* or of intrinsic essence, since it does not matter in this adjudication which it is, as long as the relation to the future performance is necessary and indisputable. It is here submitted that the relation is intrinsic to the essence.

¹⁴⁶ 312 U.S. 38 (1941).

¹⁴⁷ Petition for Writ of Certiorari, *supra* at note 54, at page 8.

¹⁴⁸ *Frost v. Coeur D’Alene Mines Corp.*, 312 U.S. 38, 39 (1941).

register the stock with the Securities and Exchange Commission. There was no other irregularity involved. There was no harm inuring to the public, no fraud, no misrepresentation nor non-disclosure. The Supreme Court of the United States noted that "the challenged contract bears no evidence of criminality and is fair upon its face . . ." ¹⁴⁹ It then cited the broad purpose of the Act:

The essential purpose of the statute is to protect investors by requiring publication of certain information concerning securities before offered for sale.¹⁵⁰

To this purpose the Supreme Court added the general rule against the enforcement of corrupt contracts by saying: ". . . contracts in contravention of public policy are not enforceable . . ." This principle "should be applied with caution and only in cases plainly within the reasons on which that doctrine rests. It is only because of the dominant public interest . . ." ¹⁵¹ Finally, in one paragraph the Supreme Court makes the controlling distinction between contracts which have no essential relation to harm to the innocent and those which are accidentally and extrinsically illicit.

The protean basis underlying this doctrine has been stated thus—No one can lawfully do that which tends to injure the public or is detrimental to the public good. If it definitely appears that enforcement of a contract will not be followed by injurious results, generally, at least, what the parties have agreed to ought not to be struck down.¹⁵²

The Supreme Court in the *Frost* case, contrary to the Kaiser-Frazer allegations, has enunciated exactly the general rule applicable to the *Otis* case and has equally exactly distinguished its application to the facts in *Frost*. Consider the five elements of the rule. In *Frost* (1) There was no misrepresentation, no falsity or evil of any kind. There was only the violation of the positive-law enactment. (2) Whatever evil could be attributed to the non-registration was not integral to the agreement in any way, but was an extrinsic factor that in no way would influence or change the contract were it cured, i.e., by registration. (3) This same non-registration, in and of itself, did not have an inseverable relation to the harm or detriment of innocent third parties, or as the Court expressed it, tend "to injure the public." Of the five elements none but the first was present.

Kaiser-Frazer impugns the stand of the Circuit Court and claims

¹⁴⁹ Ibid., at 42.

¹⁵⁰ Ibid., at 40.

¹⁵¹ Ibid., at 44.

¹⁵² Ibid.

that it "did not cite but apparently ignored the"¹⁵³ *Frost* case. There is a very strong rebuttal of this allegation in the case of *Judson v. Buckley*.¹⁵⁴ The *Judson* case, moreover, carries forward the delicate reasoning developed in connection with the application of the rule against enforcement of corrupt contracts. In the *Judson* case, two of the same three judges considered the case as sat in the *Otis* case, Augustus N. Hand and Clark. Judge Hand wrote both *Otis* and *Judson*. Since the *Judson* case is an *a fortiori* application of the rule, there is little difficulty in asserting that Judge Hand would not have held differently had he seen the *Frost* opinion. In short, there is no reason at all to assume he did not see it.

In the *Judson* case there was an actual misrepresentation in the prospectus. The question then in *Judson* was: Did this lie perjure to the harm of the public, and was it an integral and essential element of the contract? The lie was a misrepresentation of the true ownership of the securities offered for sale. The question again was of enforcement of a contract. The Court, by Judge Hand, held that this misrepresentation could not "mislead prospective purchasers as to the value of the stock or really prejudice them in any way" and "the public offense" committed was therefore "one of little practical significance."¹⁵⁵ Therefore there was no reason to block enforcement of the contract. This is certainly a stronger case for *non-enforcement* than the *Frost* facts. In *Judson* there was a lie involved. Certainly if Judge Hand wrote *Judson* he would write *Frost*. But if he would write *Judson* and still write *Otis*, the distinctions are admirably highlighted and the very important differences between the presence and absence of the five elements of the rule are engraved deeply in the three opinions.

In *Judson* there was a falsity, but it was not integral to the agreement (since it mattered little to the value of the shares who owned them) and it did not inevitably look to the harm of the public (it could have been cured, and there was no harm if it were not).

The Rule Applied in Otis

Some brief speculation on the various possible results attendant on a sale by *Otis* to the public will illustrate the inherent reason-

¹⁵³ Petition for Writ of Certiorari, *supra* at note 54, at page 8.

¹⁵⁴ 130 F. 2d 174 (C.A. 2d, 1942) cert. denied, *Buckley v. Judson*, 317 U.S. 679 (1942).

¹⁵⁵ *Ibid.*, at 179.

ableness of the rule against enforcement. The rule in principle is clear. When applied to all the hypotheses and possibilities it is pellucid. The assumption continues that Otis had full knowledge at the closing.

If Otis were to buy from Kaiser-Frazer and resell to the public, a cause of action for damages or rescission would immediately arise in the innocent purchaser against both Kaiser-Frazer and Otis. Thus Otis, by the sale, would at the same time harm innocent buyers and subject itself to a suit for damages or rescission. The law cannot knowingly let anyone proceed in a course of action that will harm the innocent. Nor could Otis be legally allowed to perform an act illegal in itself or for which it would be legally liable in a suit by investors. Termination, therefore, was the only course, both in protection of Otis from litigation and of the public investor from deception and detriment.

If Otis had anything less than full knowledge, say a suspicion of the true facts, Otis would still be expected to terminate rather than risk the burden of an illegal sale to the public investor and the onus of a litigation in which it would have to prove a reasonable investigation begun on the basis of the suspicion. Even the possibility of damages or rescission under such conditions would indicate termination. To go ahead in the face of this suspicion would also be in derogation of the rights of the public investor especially when they were entrusted to Otis as to a fiduciary, as specified in the Act.

Had there been termination for reasons completely foreign to knowledge of misrepresentation, Otis would be allowed any defense to its action that the facts would support, and hence any later discovered evidence of misrepresentation could, and should be, adduced in support of the termination.

Were Kaiser-Frazer, on the other hand, permitted to recover in the instant action, the amount of the judgment would be in effect the very money or its equivalent that the sale would have deceptively extorted from the public on the basis of the misrepresentation. If Otis were forced to pay Kaiser-Frazer, it would be for refusing to deceive the innocent public and subject itself to an action for damages or rescission.

Viewed in another way this would be a suit between two who both knowingly set out to deceive the public. It would be impossible to award damages to one such deceiver because the other refused to go through with the deception.

The Question of Estoppel

“... (6) and notwithstanding alleged estoppel due to Otis’ knowledge.”

From *Part II: Solution*

Continuing the assumption that Otis had full knowledge of the misrepresentation Kaiser-Frazer averred that Otis was estopped from claiming breach of warranty. Were it true that the contract was a private bargain, isolated from the future deception of the innocent investor, and that the future deception was not an intrinsic element of the agreement—which is an assumption contrary to the facts and hence supposes a contract and a state of affairs altogether different from the instant considerations—then, as between Kaiser-Frazer and Otis only, Otis could not adduce the breach of the warranty of full-disclosure. But in that supposition the contract would not be the contract that has been so closely analyzed thus far. It would involve a sale of stock to Otis, with no thought of a future re-sale to the public. If that were the case there would be no need to worry about the protection of the investor, because no investor was, or would be, contemplated.

So, in fact, if Otis had to rely on the breach of warranty in order to bar recovery by Kaiser-Frazer, it would be a totally different matter. Otis relies on the breach of warranty only on the other half of the double hypothesis, namely, if it did *not* have knowledge. If it did not have knowledge, the breach of the warranty would bar the action of Kaiser-Frazer, and no estoppel would prohibit Otis from claiming it.

But once Otis shifts, *ex arguendo*, to the assumption that it did have knowledge, it must, perforce, forget about the warranty. The burden henceforward for proving unenforceability is the fact that the misrepresentation is integral to the contract and that it has an inevitable relation to the innocent public. This does not mean that Otis could not and does not and should not found its case on this point, even if it could prove that it did *not* have knowledge at the time of the signing or even closing, since then it would have an *a fortiori* case in that the recovery of Kaiser-Frazer would be barred for two reasons, (1) breach of warranty of truth in relation to Otis and (2) the intrinsic unenforceability of a corrupt contract aimed at harm to the innocent. Merely because Otis did not have knowledge

of such a contract does not make it any the less corrupt if it had only one purpose, the deception of the investor. Otis could have been the unwitting tool in a sale to the public. The five elements of the definition of a corrupt contract would be verified irrespective of Otis' knowledge.

Thus at this stage of the reasoning the question of the warranty has been disposed of, and consequently the concomitant question of the estoppel from claiming breach of that warranty. In one phrase, Otis' knowledge simply does not enter into the question at this point, other than to make Otis more able to terminate rather than carry through unwittingly, and unknowingly to deceive the public. The only question now is whether the contract is intrinsically vitiated. If so, it cannot be enforced. To say that Otis is estopped, is missing the point. In this argument Otis is in fact not claiming anything for itself. If it had knowledge it would be estopped from claiming anything of benefit to itself. It is merely now calling the court's attention to the rights of the innocent third party, and telling the court that it could not go ahead with the arrangement because it would have jeopardized those rights and incidentally subjected itself to suit by the injured purchasers. The question therefore is beyond the equities of the parties. As the Circuit Court said: "This is so regardless of the equities of the parties for . . . the very meaning of public policy is the interest of others than the parties and that interest is not to be at the mercy of the defendant alone."¹⁵⁶

Therefore this contract is declared invalid for two reasons: (1) It is inherently evil, in that it stipulates in its essence a deception, and (2) it is harmful of the innocent. Thus it would be unenforceable either simply to eliminate the evil or to protect the innocent. If two agree to a murder the contract is invalid for two reasons, first because evil cannot be legally enforceable, and second the victim must be saved. Therefore no matter what Otis knew or did not know about the evil, the contract was invalid. Merely to say, "I know about the misrepresentation, go ahead and deceive the public," hardly renders the contract valid. It is really a misconception to think that estoppel plays any part in this argument at all. Estoppel bars personal claims of Otis, but cannot stop the court's recognition of the intrinsic immorality of a contract or the danger to the innocent simply because Otis happens *per accidens* to benefit by a declaration of the court in protection of the rights of the public investor.

¹⁵⁶ 195 F. 2d 838, 844 (C.A. 2d, 1952).

A further very refined point in this matter of estoppel might be discussed. There is another way of saying that the whole question of estoppel is not relevant here. It is this. Because one of the intrinsic elements of the instant contract, and all such corrupt contracts where the evil is inherent to the essence of the contract and hence inevitable in its performance, is harm to the innocent public, the very supposition is that this harm is based on *absence of knowledge* in the purchaser. Thus, it is true to say that the question of estoppel is irrelevant if we mean the estoppel of the *second party contractor* (since he is not really making the claim of injury) but not if we mean the estoppel of the *third party purchaser*, since he is not *absolutely* barred from the rule of estoppel, if in a de facto case, such a sale were made and such a purchaser did have knowledge. But that again would be a contrary-to-fact supposition, since the very rule posits an "innocent" purchaser. The supposition is, and rightly so, that none of the public will have knowledge since the instrument is necessarily deceptive. By such suppositions the "intrinsic" evil is being removed from the contract. (But this is not true of all contracts that are invalid through evil intrinsic to their essence, since some cannot have the evil cured even by knowledge or consent, e.g., a contract to statutory rape. In such contracts, estoppel, in truth, *never* applies.) So it still stands that the question of estoppel is foreign to any discussion of the unenforceability of corrupt contracts.

This is the *Otis* case. Seen in its proper perspective it can teach us much. Beyond the superficialities, the eye-catching and emotion-stirring details—the unusual termination, the NASD suspension, the Masterson squabble, the SEC investigations, the Heller inquiries, even beyond the fascinating factual convolutions and ramifications, beyond all this there lies one single and outstanding feature of *Otis* that repays all this lengthy analysis. *Otis* is a vindication of our American philosophy of life and law. Every force in *Otis* propelled the Court to a decision of expediency, to a pragmatic nod of approval that would have been a kowtow to a hasty public opinion, to an understandable reaction to the questionable conduct of *Otis* throughout the venture, even to the status quo set up by a strong lower court opinion. In face of all this the Court stood firm and relied on the sound moral philosophy at the base of our law, and went behind statutes and contract alike to the fundamental natural-law principle

of the unenforceability of contracts in derogation and injury of the rights of the innocent and unprotected public investor. This action is more important than the capable handling of the complexity of the facts, even more important than the reaffirmation of the inviolability of the disclosure provisions of the Securities Acts, and strengthens our faith in our fundamental law and the American system of courts and justice.